

Taxation of Business Entities Study Guides

by Professor Lon Sobel



**Southwestern Law School
Spring Semester 2011**

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Southwestern Law School
TAXATION OF BUSINESS ENTITIES
Syllabus, Course Requirements, and Grading Criteria
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Spring 2011

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I. COURSE MATERIALS

A. Required Text or Course Materials

The assigned readings are in Study Guides written especially for this course by Professor Sobel (available in the Southwestern Printshop and online at <http://tax.carolon.net>), and in CORPORATE AND PARTNERSHIP TAXATION, SIXTH EDITION, by Stephen Schwarz and Daniel J. Lathrope (Thomson/West 2008). The Study Guides will contain: excerpts (for each class) from the Internal Revenue Code and Treasury Regulations; reading assignments from the Schwarz/Lathrope book; Professor Sobel's explanations and commentary; and multiple choice questions about each class session's assigned topics.

B. Recommended Text

None. (But if you are doing the assigned readings and attending class, and you're still having trouble, see me during office hours and I will show you what additional books are available.)

II. COURSE REQUIREMENTS

A. Class Preparation

Students are expected to have read the assigned materials. Class discussion will commence with the assumption that everyone is thoroughly familiar with the assigned materials. In addition to reading the assigned materials, *answer the questions in the Study Guide, and make notes to yourself about why you answered the questions the way you did.* We will discuss the questions in class, because they will help you understand tax law; but the questions will help you, *only* if you have considered them carefully *before* class, and come to class prepared to participate in discussions about them.

B. Attendance

Regular and punctual attendance is required. A student may be administratively withdrawn from this course if he or she is absent from more than 20% of the regularly scheduled class sessions. Each student is responsible for keeping track of his or her absences. Attendance will be taken at the start of class through distribution of an attendance sheet. If you are not in your seat at the beginning of class and do not personally initial the sign-in sheet at that time, you are considered absent. The Student Honor Code remains in effect. Students may initial only their own names, not those of other students. Lack of preparation, early departure, or inappropriate behavior may result in a student being marked absent.

C. Grading Criteria and Evaluation

Your grade in this course will be based entirely on your performance on a take-home exam. *The exam will be distributed on the last day of class, Wednesday, April 27th, and it will be due by noon on Monday, May 2nd. (Turn in your answers at the Faculty Support window on the 3rd or 4th floor of the Bullocks Wilshire Building.) Please take this exam schedule (especially the May 2nd due date) into account in allocating your study time for this and your other courses.*

Grades for this course will be awarded based upon an alphabetical system and will strictly follow Southwestern's grading policies. After a grade is awarded for the course, I am happy to discuss ways to improve a student's performance. In accordance with law school policy, however, assigned grades will not, and cannot, be changed except for mathematical/clerical errors.

D. Special Rules Regarding Electronic Devices

Recording of class meetings is permitted only if the professor is first asked and gives permission. Recording a class without permission is prohibited. If a student is granted permission, recording is condition upon the student's agreement to share any recording with any classmate who makes a reasonable request.

E. Statement of Reasonable Accommodations

Students who need accommodations due to disabilities should contact the Counselor/Disability Specialist in the Diversity Affairs Office. The office is located in BW 361 and can be reached at (213) 738-6888 or disability@swlaw.edu.

It is the policy and practice of Southwestern Law School to comply with the Americans with Disabilities Act of 1990 as amended by the ADA Amendments Act of 2008, Section 504 of the Rehabilitation Act, and state and local requirements regarding students and applicants with disabilities. Southwestern will make every effort to provide reasonable accommodations for students with medical, attentional, psychological, learning, or temporary disabilities.

Accommodations are not provided to give a student an unfair advantage over other students, but simply to allow a student with disabilities to have an equal opportunity to be successful.

A student has the responsibility to meet with the Counselor/Disability Specialist as early as possible to discuss his or her request for special accommodations. Students who do not seek accommodations need not make their disabilities known. Further information regarding procedures, policies and documentation required is available in the Student Handbook.

F. Office Hours/Instructor Availability

Office: BW 325

Office Hours: Mondays, Tuesdays and Wednesdays, 2:00 pm – 4:00 pm, and at your convenience (just let me know what day and time is good for you).

I also will be on campus on other days and at other times. Please feel free to drop into my office, unannounced, whenever you see me there.

III. ASSIGNMENTS:

The reading assignments and topics covered in this class are set forth below. Assignments are subject to change or supplementation.

Class	Day	Date	Topic	Study Guide	Schwarz & Lathrope	✓
Doing Business as an "Entity"						
1	Mon	Jan 10	Introducing Business "Entities" Classifying Entities for Non-Tax Purposes Taxing Business Entities – An Overview Classifying Entities for Tax Purposes Taxing Business Entities – California Taxes Determining Whether an "Entity" Exists Classifying Entities	1	81- 102	
Forming a Business						
2	Wed	Jan 12	Forming a Partnership Contributing Property Contributing Services Deducting Start-Up Expenses	2	437-454	
3	Wed	Jan 19	Forming a Corporation Contributing Services Contributing Property	3	121-137	
4	Mon	Jan 24	Contributing Property Incorporating a Going Business	4	137-148	
5	Wed	Jan 26	Capitalizing with Debt Deducting Start-Up Expenses	5	148-149 152-161	
Operating a Business						
6	Mon	Jan 31	Operating a Partnership Taxing Partnership Operations	6	459-472	
7	Wed	Feb 2	Allocating Partners' "Distributive Shares"	7	472-491	
8	Mon	Feb 7	Allocating Partners' "Distributive Shares"	8	491-518	
9	Wed	Feb 9	Taxing Partner-with-Partnership Transactions Scrutinizing Family Partnerships	9	521-529	
10	Mon	Feb 14	Distributing Cash and Property to Partners Consequences to Partners	10	555-563	
11	Wed	Feb 16	Distributing Cash and Property to Partners Consequences to Partnership Taxing Fringe Benefits Paying Payroll Taxes	11	563-567	
12	Wed	Feb 23	Operating a C Corporation Taxing Corporate Operations	12	107-116	
13	Mon	Feb 28	Taxing Dividends and Other Distributions Taxing Fringe Benefits Paying Payroll Taxes	13	171-183	
14	Wed	Mar 2	Preventing Tax Avoidance	14	276-290	

Class	Day	Date	Topic	Study Guide	Schwarz & Lathrope	√
15	Mon	7	Operating a Subchapter S Corporation Electing to be a Subchapter S Corporation Determining Taxable Income	15	399-413	
16	Wed	Mar 9	Taxing S Corporation Shareholders Dealing with Items Not Covered in Subchapter S Taxing Fringe Benefits Paying Payroll Taxes	16	413-421 429-430	
Transferring a Business						
17	Mon	Mar 14	Transferring a Partner's Interest Selling a Partner's Interest	17	534-550	
18	Wed	Mar 16	Liquidating a Partner's Interest	18	577-589	
19	Mon	Mar 21	Transferring the Interest of a Deceased Partner	19	598-602	
20	Wed	Mar 23	Transferring a Shareholder's Stock Selling a Shareholder's Stock Redeeming a Shareholder's Stock	20	161-165 189-190 194-208	
21	Mon	Apr 4	Redeeming a Shareholder's Stock	21	215-222	
22	Wed	Apr 6	Transferring a Partnership's Business Transferring a Corporation's Business Transferring Assets in a Taxable Transaction Transferring Stock in a Taxable Transaction	22	258-272	
23	Mon	Apr 11	Reorganizing a Corporation, Tax-Free	23	291-297 318-326	
24	Wed	Apr 13	Dividing a Corporation, Tax-Free	24	339-342 358-367	
Ending a Business						
25	Mon	Apr 18	Liquidating a Partnership Going Out of Business Making Major Changes in the Ownership of the Partnership's Business	25	590-596	
26	Wed	Apr 20	Liquidating a Corporation Taxing the Shareholders Taxing the Corporation	26	243-254	
Review						
27	Mon	Apr 25	Integration of Semester's Topics Recap of Section 754 Elections and Other Topics	27	-	
28	Wed	Apr 27	Student Questions Distribution of Take-Home Exam	-	-	
	Mon	May 2 Noon	Deadline for turning in take-home exam Faculty Support window – BW 3rd or 4th floor			

Study Guide 1

DOING BUSINESS AS AN "ENTITY"

Introducing Business "Entities"

Classifying Entities for Non-Tax Purposes

Taxing Business Entities – An Overview

Classifying Entities for Tax Purposes

Determining Whether an "Entity" Exists

Classifying Business Entities for Federal Tax Purposes

Classifying Business Entities for California Tax Purposes

DOING BUSINESS AS AN "ENTITY"

Introducing Business "Entities"

In the Survey of Federal Income Tax course, you studied the taxation of Sole Proprietorships. They are, you will recall, businesses owned by one person him or herself, not through an entity of any kind. When individuals do business under fictitious business names, they are doing business as sole proprietors. Using a fictitious business name – often referred to in everyday conversation as a "dba" (which is short for "doing business as") – does not, by itself, create a separate entity.

In this class, we will study the taxation of businesses that are owned as entities that are separate and distinguishable from the person or people who own them. There are several different kinds of businesses entities; and their principal features are summarized in the short (two-page) reading assignment, just below. Before you read those pages, though, let me give you the context in which your clients will have to make decisions about which kind of entity to use. Consider the following hypothetical:

Anne, Beth, Carl and Doug are starting a new business together. Each of them will be contributing something to the business:

- Anne will be contributing the start-up cash the business will need until it begins earning income;
- Beth will be contributing the real estate the business will use (i.e., office or factory space);
- Carl will be contributing equipment the business will use; and
- Doug will be contributing his services.

Anne, Beth and Carl will not be working for the business; they will contribute only cash, real estate and equipment, respectively. And Doug will be contributing only his services, not any cash, real estate or equipment.

Now, with this new business in mind, read the following assignment, and think about how each of the entity types described below might be used by Anne, Beth, Carl and Doug.

Classifying Entities for Non-Tax Purposes

Read (in Schwarz & Lathrope)

Pages 81-82

Questions about Classifying Entities for Non-Tax Purposes

Answer the following questions without regard to the tax consequences of your answers. This entire course is about tax consequences; but I want it to be clear to you that non-tax factors are important too.

1. Is it actually necessary for Anne, Beth, Carl and Doug to form any entity at all? That is, would it be possible:
 - for Anne to lend money to Doug, Beth to lease real estate to Doug, Carl to rent equipment to Doug; and
 - for Doug to do business as a sole proprietor?
2. If your answer to Question 1 was "no," why not? If your answer to Question 1 was "yes," why might Anne, Beth, Carl and Doug:
 - prefer to do it the way described in Question 1, rather than form an entity, or
 - prefer to form an entity, rather than do it that way?
3. Suppose that Anne, Beth, Carl and Doug decide that they do want to form an entity. Is it certain that *one* type of entity will be best for *all* of them, or is it possible they will disagree – for good reason – about which entity is best? If they might disagree, why would they? That is, why would the advantages and disadvantages of each type of entity be different for Anne, Beth, Carl and Doug?

Taxing Business Entities – An Overview

All types of business entities are *not* taxed alike. (That's why this course exists.) The next reading assignment describes the highlights of the ways each type of entity is taxed. In other words, the next reading assignment provides a first glimpse into the ways in which types of business entities are taxed differently. As you read the next assignment, don't try to commit it to memory; during the semester, we'll come back to all of its points, in context and in detail. For now, simply look for the answers to the questions below, so you're certain you have grasped the highlights.

Read (in Schwarz & Lathrope)

Pages 82-90

Questions about Taxing Business Entities – An Overview

4. If Doug were to borrow money from Anne, lease property from Beth, rent equipment from Carl, and do business as a sole proprietor, which of the following would be true?
 - a. Doug would pay tax on his taxable income, *including* the taxable income of his sole proprietorship; and the sole proprietorship would not *itself* pay tax itself on its taxable income.
 - b. Doug would pay tax on his taxable income, *not* including the taxable income of his sole proprietorship; and the sole proprietorship *itself* would pay tax on its taxable income.

5. If Anne, Beth, Carl and Doug were to form a partnership, which of the following would be true?
 - a. Each of them would pay tax on his or her own taxable income, *not* including the taxable income of the partnership; and the partnership itself would pay tax on its taxable income.
 - b. Each of them would pay tax on his or her taxable income, *including* his or her share of the partnership's taxable income; the partnership itself would *not* pay tax, though the partnership would file a tax return of its own, reporting its taxable income (or loss).
6. If Anne, Beth, Carl and Doug were to form a C corporation, which of the following would be true?
 - a. Each of them would pay tax on his or her own taxable income, *not* including the taxable income of the C corporation; and the C corporation itself would pay tax on its taxable income.
 - b. Each of them would pay tax on his or her taxable income, *including* his or her share of the C corporation's taxable income; the C corporation itself would *not* pay tax, though the C corporation would file a tax return of its own, reporting its taxable income (or loss).
7. If Anne, Beth, Carl and Doug were to form an S corporation, which of the following would be true?
 - a. Each of them would pay tax on his or her own taxable income, *not* including the taxable income of the S corporation; and the S corporation itself would pay tax on its taxable income.
 - b. Each of them would pay tax on his or her taxable income, *including* his or her share of the S corporation's taxable income; the S corporation itself would *not* pay tax, though the S corporation would file a tax return of its own, reporting its taxable income (or loss).
8. Which types of entities result in what is called a "double tax"?
 - a. Partnerships.
 - b. C corporations.
 - c. S corporations.
 - d. Both "b" and "c".

Classifying Entities for Tax Purposes

You probably noticed that the Schwarz & Lathrope book described eight types of business entities recognized by *state* law:

- Sole Proprietorships
- C Corporations
- S Corporations
- General Partnerships
- Limited Partnerships
- Limited Liability Partnerships
- Joint Ventures
- Limited Liability Companies

By contrast, Questions 4 through 7 above only asked about the federal tax treatment of four types of organizations: sole proprietorships, partnerships, C corporations and S Corporations. The issue to be explored now is whether Questions 4 through 7 asked about four types of entities, rather than eight, because life is short, and some things just don't need to be beaten to death, or whether those questions only asked about four types of entities because federal tax law lumps all types of business entities into just four categories.

Determining Whether an "Entity" Exists

We begin with the question of what sorts of arrangements constitute "entities." This may sound like a philosophical question, rather than a legal one. But it's not philosophical; it is legal. Here's why: Recall that although "Anne, Beth, Carl and Doug are starting a new business together," we considered the possibility that Anne would lend money to Doug, Beth would lease him real estate, and Carl would rent him equipment. If this were the arrangement they decided to use, would their arrangement be an "entity" for federal tax purposes? That is the question addressed in the next reading assignment.

Read (in Schwarz & Lathrope)

Pages 91-97

Treasury Regulation provisions re Whether an "Entity" Exists

Reg. § 301.7701-1 Classification of organizations for federal tax purposes.

(a) Organizations for federal tax purposes—

- (1) In general. The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.
- (2) Certain joint undertakings give rise to entities for federal tax purposes. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

Questions re Whether an "Entity" Exists

9. Would a separate business entity exist if
- Doug borrowed money from Anne, pursuant to a promissory note that required him to pay her interest at prevailing interest rates, without regard to whether or not he earns a profit or the amount of any profit he might earn,
 - Doug leased property from Beth, pursuant to a lease that required him to pay her rent at prevailing rental rates, without regard to whether or not he earns a profit or the amount of any profit he might earn, and
 - Doug rented equipment from Carl, pursuant to a rental agreement that required Doug to pay Carl rent at prevailing rental rates, without regard to whether or not he earns a profit or the amount of any profit he might earn?
- a. Yes, because even though the four of them would not have a partnership as a matter of state law, the classification of business entities for federal tax purposes is a matter of federal tax law rather than state law.
- b. No, because even though the classification of business entities for federal tax purposes is a matter of federal tax law, this arrangement does not involve the division of the profits of the business among the four of them.
10. Would a separate business entity exist if
- Doug borrowed money from Anne, pursuant to a promissory note that required him to pay her interest in an amount equal to 25% of the profits, if any, of his business,
 - Doug leased property from Beth, pursuant to a lease that required him to pay her rent in an amount equal to 25% of the profits, if any, of his business, and
 - Doug rented equipment from Carl, pursuant to a rental agreement that required Doug to pay Carl rent in an amount equal to 25% of the profits, if any, of his business?
- a. Yes, because even though the four of them would not have a partnership as a matter of state law, the classification of business entities for federal tax purposes is a matter of federal tax law rather than state law, and this arrangement appears to involve the division of the profits of the business among the four of them.
- b. No, because even though the classification of business entities for federal tax purposes is a matter of federal tax law, this arrangement seems equivalent to a land owner renting the land to a farmer in return for a share of the farmer's crops – an arrangement which the Regulations say does not create a separate entity (i.e., does not create a partnership between the land owner and the farmer).
- c. It's not clear how the law would classify this arrangement; either "a" or "b" could be right.

Classifying Business Entities for Federal Tax Purposes

For the rest of this course, we will assume that your clients wish to do business as an "entity." The next reading assignment describes the types of entities recognized by federal tax law, and what the characteristics are of each. You will be pleased to see that only three types are mentioned: corporations; partnerships; and "disregarded" entities which is what we have been calling "sole proprietorships." You also will see that the book describes the standards that were used to classify entities both before 1997 and since 1997. The pre-1997 standards are now history; it'll be useful for you to know that they once existed, in case you some day read a pre-1997 case and notice that the standards used by the judge

are not the ones you'll learn in this class. The standards we'll study now are standards the Treasury adopted in 1997, in Regulations called "Check the Box Regulations."

The "Check the Box Regulations" were designed to simplify and make more certain the process of classifying business entities for federal tax purposes; and it appears that they have. The reason they are called "Check the Box Regulations" is that the owners of some types of business entities are entitled to choose which type of tax entity they would like to have; and they indicate their choice by checking boxes on Form 8832 (a copy of which is at the end of these Study Guides).

Although Form 8832 is easy to fill out, it isn't essential for all clients. That's because the Regulations themselves provide default classifications, for those who don't file Form 8832. It looks (to me) as though in most cases, the defaults are exactly what clients would choose, once they have decided what type of entity – under *state* law – they wish to use.

Read (in Schwarz & Lathrope)

Pages 97-102

Read

Form 8832 (a copy of which is at the end of these Study Guides)

Treasury Regulations re Classifying Entities for Federal Tax Purposes

Here are (excerpts from) the "Check the Box Regulations"

Reg. § 301.7701-2 Business entities; definitions.

- (a) Business entities. . . . [A] business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under Sec. 301.7701-3) that is not . . . subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.
- (b) Corporations. For federal tax purposes, the term corporation means-
 - (1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation . . . ;
 - (2) An association (as determined under Sec. 301.7701-3); . . .
- (c) Other business entities. For federal tax purposes-
 - (1) The term partnership means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.
 - (2) Wholly owned entities-(i) In general. A business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner. . . .

Reg. § 301.7701-3 Classification of certain business entities.

- (a) In general. A business entity that is not classified as a corporation under Sec. 301.7701-2(b)(1) . . . can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under Sec. 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification . . . until the entity makes an election to change that classification. . . .
- (b) Classification of eligible entities that do not file an election-
- (1) Domestic eligible entities. . . . [U]nless the entity elects otherwise, a domestic eligible entity is-
- (i) A partnership if it has two or more members; or
- (ii) Disregarded as an entity separate from its owner if it has a single owner.

Questions re Classifying Business Entities for Federal Tax Purposes

11. If Anne, Beth, Carl and Doug form a corporation under California state law, how will their corporation be classified for federal tax purposes?
- As a corporation.
 - As a partnership.
 - If they file a Form 8832, they can choose between corporation and partnership.
12. If Anne, Beth, Carl and Doug form a general partnership under California state law, how will their corporation be classified for federal tax purposes?
- As a corporation.
 - As a partnership.
 - If they file a Form 8832, they can choose between corporation and partnership.
13. If Anne, Beth, Carl and Doug form a limited partnership under California state law, how will their corporation be classified for federal tax purposes?
- As a corporation.
 - As a partnership.
 - If they file a Form 8832, they can choose between corporation and partnership.

14. If Anne, Beth, Carl and Doug form a limited liability company under California state law, how will their corporation be classified for federal tax purposes?
- As a corporation.
 - As a partnership.
 - If they file a Form 8832, they can choose between corporation and partnership.

Classifying Business Entities for California Tax Purposes

This course is going to focus on *federal* – not state – taxation of business entities. Generally speaking, state tax laws are similar to federal tax law, so that decisions made with an eye on federal law will be right under state law too. However, California (and perhaps other states) impose state income taxes on *some* types of entities, even when federal law would not. Because the amount of state taxes imposed (by California, at least) is not trivial, it’s important to know that for *state* tax purposes, some types of entities are more “expensive” to operate than others. That knowledge may well influence what type of entity clients will choose under state law, even though their choice will have no effect on their federal tax obligations.

Entity Type Under California Law	Entity Type Under Federal Law by Default	Minimum Federal Tax Per Year	Minimum California Tax Per Year
Sole Proprietorship	Sole Proprietorship	\$0	\$0
General Partnership	Partnership	\$0	\$0
Limited Partnership	Partnership	\$0	\$800
Limited Liability Partnership (in California, used only by lawyers, accountants and architects)	Partnership	\$0	\$800
Joint Venture	Sole Proprietorship or Partnership	\$0	\$0
Limited Liability Company	Sole Proprietorship (1 owner) Partnership (2 or more owners)	\$0 \$0	\$800 + \$900 or more if gross revenue is greater than \$250,000
C Corporation	Corporation	\$0	\$800
S Corporation	Corporation	\$0	\$800 + 1.5% of income

Study Guide 2

FORMING A BUSINESS

Forming a Partnership

- Contributing Property
 - Contributing Services
 - Deducting Start-Up Expenses
-

FORMING A BUSINESS

Forming a Partnership

Anne, Beth, Carl and Doug are starting a new business together. The particular type of entity they choose to use for their business will depend, in part, on the tax consequences of their choice. Those consequences will begin at the very start of their relationship, when they first form their entity. Ultimately (that is, by the time we finish Study Guide 5), we will want to be able to advise them what the tax consequences will be of their choosing each type of entity, so they can compare and contrast those consequences, beginning at the start-up stage.

Let's begin with the tax consequences of their forming a partnership. The *federal* tax consequences will be the same, whether they form a general or limited partnership, or any other type of state law entity that federal law classifies as a "partnership." (Recall, though, that some types of entities that are classified as partnerships for federal tax purposes are taxed by the *state of California* more heavily than other types.)

Each of them will be contributing something to the partnership:

- Anne will be contributing the start-up cash the business will need until it begins earning income;
- Beth will be contributing the real estate the business will use (i.e., office or factory space);
- Carl will be contributing equipment the business will use; and
- Doug will be contributing his services.

(Recall too that Anne, Beth and Carl will not be working for the business; they will contribute only cash, real estate and equipment, respectively. And Doug will be contributing only his services, not any cash, real estate or equipment.)

Suppose that in return for their contributions, each of them will receive an equal, 25% interest in the partnership. The creation of the partnership *could be* a taxable transaction for the partnership *and* for each of the partners, because each will be exchanging something in return for something else. The partnership will be exchanging 25% of itself in return for: cash; real estate; equipment; and services. And each of the partners will be exchanging cash, real estate, equipment or services, in return for 25% of the partnership.

You'll recall (from the Survey course) that section 1001 of the Internal Revenue Code makes gains (or losses) taxable, when they are realized as a result of sales or exchanges of property, unless some other section of the Code provides otherwise. The question to be considered now is whether the exchange of cash, real estate, equipment and services for an interest in a partnership is taxable under Code section 1001, or whether some other section of the Code makes the exchange tax-free or tax-deferred.

First, we'll need to figure out how to determine the value of what the four partners and the partnership "realized" from the exchange. There is a brand-new partnership. No one has offered to buy it from them, yet (and no one will, until later in the semester). Nevertheless, because Anne will be contributing cash, we can put a value on what every partner will be contributing, and thus on the value of what the partnership will be receiving.

Questions re value of contributions

1. If Anne contributes \$100,000 for her 25% interest in the partnership, and Beth will be receiving a 25% interest in the partnership for the real estate she will be contributing, what is the fair market value of Beth's real estate, as of the time she contributes it? (The answer to this question is not in the Schwarz & Lathrope book. Just think about it for a moment, and the answer will come to you, if it didn't immediately.)
 - a. \$100,000.
 - b. Whatever Beth paid for the real estate when she first bought it.
 - c. Beth's adjusted basis in the real estate.
 - d. It will be necessary to have the real estate appraised, in order to determine its value.
2. If Anne contributes \$100,000 for her 25% interest in the partnership, and Carl will be receiving a 25% interest in the partnership for the equipment he will be contributing, what is the fair market value of Carl's equipment, as of the time he contributes it?
 - a. \$100,000.
 - b. Whatever Carl paid for the equipment when he first bought it.
 - c. Carl's adjusted basis in the equipment.
 - d. It will be necessary to have the equipment appraised, in order to determine its value.
3. If Anne contributes \$100,000 for her 25% interest in the partnership, and Doug will be receiving a 25% interest in the partnership for the services he will be contributing, what is the fair market value of Doug's services, as of the time he contributes them?
 - a. \$100,000 (assuming Doug is not going to be paid a salary for his services).
 - b. Whatever Doug would be paid for providing the same services to a company in which he did not own an interest.
 - c. Whatever Doug says the value of his services will be to the partnership.
 - d. It will be necessary to have Doug's services appraised, in order to determine their value.
4. If Anne contributes \$100,000 for her 25% interest in the partnership, what is the fair market value of that 25% interest at the time the partnership is formed?
 - a. \$100,000.
 - b. Some other amount. (What amount?)

5. If Anne's 25% interest in the partnership has a value of \$100,000, what is the value of the entire partnership?
- \$400,000.
 - \$100,000.
 - \$25,000.
 - It will be necessary to have the partnership appraised, in order to determine its value.

Assume (even if you didn't think so) that the partnership's value is \$400,000, so that the value of each partner's 25% interest is \$100,000. If Beth's *basis* in the real estate she'll be contributing is \$50,000, and Carl's *basis* in the equipment he'll be contributing is \$25,000 (notice I said "basis," *not* "value"), Beth and Carl *realized* a gain, didn't they? Notice that I said "realized," not "recognized." This Study Guide concerns whether:

- Beth and Carl must recognize the gains they realized
- Doug must recognize any gain, and
- the partnership must recognize any gain.

(Anne didn't realize any gain to recognize, did she? That is, she paid \$100,000 in cash for an interest in the partnership that we just assumed had a value of \$100,000.)

Contributing Property

Read (in Schwarz & Lathrope)

Pages 437-441

Internal Revenue Code provision re Contributing Property

§ 721. Nonrecognition of gain or loss on contribution

- (a) General rule. No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

§ 722. Basis of contributing partner's interest

The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution. . . .

§ 723. Basis of property contributed to partnership

The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution. . . .

Questions re Contributing Property

6. Anne will be contributing cash to the partnership, not real or personal property. Also, the partnership doesn't have a "basis" in itself – does it? – because it's brand new and hasn't yet purchased any assets. This means that the partnership sold 25% of itself – something having a basis of \$0 – for \$100,000. Therefore, which of the following is true?
 - a. The partnership will have to recognize a \$100,000 gain.
 - b. The partnership will not have to recognize any gain, because the "property" referred to in Code section 721 includes cash.
7. If Beth purchased the real estate she will be contributing for \$50,000, and \$50,000 is still her basis in that real estate, and the value of the 25% partnership interest she will be receiving is \$100,000, which of the following is true?
 - a. She will realize a \$50,000 gain but will not have to recognize it.
 - b. She will realize, and will have to recognize, a \$50,000 gain.
8. Beth's basis in the partnership will be:
 - a. \$100,000 – it's value at the time the partnership is formed.
 - b. \$50,000 – her basis in the real estate she contributes to the partnership.
9. The partnership's basis in the real estate contributed by Beth will be:
 - a. \$100,000.
 - b. \$50,000.
10. If Carl purchased the equipment he will be contributing for \$100,000, and he has taken \$75,000 in depreciation deductions on that equipment so that \$25,000 is now his basis in that equipment, and the value of the 25% partnership interest he will be receiving is \$100,000, which of the following is true?
 - a. He will realize a \$75,000 gain but will not have to recognize it.
 - b. He will realize a \$75,000 gain, and will have to recognize all of it because that is the amount of the depreciation he will have to recapture.
11. Carl's basis in the partnership will be:
 - a. \$100,000 – it's value at the time the partnership is formed.
 - b. \$25,000 – his basis in the equipment he contributes to the partnership.
12. The partnership's basis in the equipment contributed by Carl will be:
 - a. \$100,000.
 - b. \$25,000.
13. Questions 8 and 11 above were answered by which Code section, and is Beth and Carl's basis in their partnership interests called "inside" or "outside" basis?
 - a. Section 722, and it is called "inside" basis.
 - b. Section 722, and it is called "outside" basis.
 - c. Section 723, and it is called "inside" basis.
 - d. Section 723, and it is called "outside" basis.

14. Questions 9 and 12 above were answered by which Code section, and is the partnership's basis in the real estate and equipment called "inside" or "outside" basis?
- Section 722, and it is called "inside" basis.
 - Section 722, and it is called "outside" basis.
 - Section 723, and it is called "inside" basis.
 - Section 723, and it is called "outside" basis.
15. Why would Anne, Beth, Carl or Doug care what his or her basis in the partnership is, or what the partnership's basis in Beth or Carl's contributions is?
- They wouldn't care.
 - Because some day, the partners may sell their interests in the partnership, and they will want to be able to calculate their taxable gains or losses, rather than pay tax on the amount they receive.
 - Because some day, the partnership may sell the real estate or equipment, and it will want to be able to calculate its taxable gains or losses, rather than pay tax on the amount it receives.
 - Both "b" and "c" are good reasons for caring about the amount of "inside" and "outside" basis.
16. If the partnership ever sells the equipment contributed by Carl, will it have to recapture the \$75,000 in depreciation that Carl took on the equipment before he contributed it to the partnership?
- Yes.
 - No.

Contributing Property Subject to Debt

Although "basis" is not a very exciting topic, it's an important one, especially when assets are sold and gain (or loss) must be reported to the IRS. Basis also is important even before assets are sold, if those assets are eligible for depreciation deductions. As a result, we're now going to consider one more "what's-the-basis?" question in a slightly more complicated – but very realistic and common – circumstance.

Assume that:

- Beth purchased the real estate she will be contributing to the partnership for \$50,000,
- \$50,000 is still her basis in that real estate, and
- the value of the 25% partnership interest she will be receiving is \$100,000.

There are a couple of additional, but alternative, facts that could be part of this scenario:

- Beth could have paid for the property in full by the time she contributes it to the partnership, in which case its \$100,000 value actually is its fair market value; *or*
- Beth could have borrowed some of the money she used to purchase the property, using the property itself as collateral for the loan, and the property will still be subject to the loan at the time Beth contributes it to the partnership.

Because people usually borrow money to buy real estate, let's assume that when Beth bought the property for \$50,000, she paid \$40,000 from her own funds and borrowed the \$10,000 balance, using the real estate as collateral by giving the lender a mortgage (in California, it would be a trust deed) to the property. This assumption raises a further possibility:

- iii. When Beth contributes the property to the partnership, the partnership will take over the obligation to repay the loan. If the loan balance is still \$10,000 at the time Beth contributes the property, this means that the property's fair market value must be \$110,000 (not just \$100,000), because Beth will be receiving a partnership interest worth \$100,000 in return for property that is encumbered by \$10,000 in debt which the partnership itself will be repaying.

The following reading assignments consider what the effect would be on Beth's basis in her partnership interest if the property she contributes is encumbered by debt.

Read (in Schwarz & Lathrope)

Scan pages 441-445. These pages describe the effect on the partners' "outside" basis – that is, their bases in the partnership – if a partnership itself buys property, using the property as collateral for a portion of the purchase price. You will recall (from the Survey course) that a taxpayer's basis in property is the full amount of the purchase price, even if the property is purchased using the property as collateral for (all or a portion of) the purchase price. These pages explain how the basis of property purchased by a partnership is allocated among partners to increase the outside basis of each partner in his or her interest in the partnership. These pages, in other words, do not themselves consider what effect Beth's contribution of encumbered property will have on her basis in the partnership. But familiarity with these pages is necessary in order to understand the next reading assignment, which does deal with Beth's basis in her partnership interest.

Read (in Schwarz & Lathrope)

Pages 446-447

Regulations re Contributing Property Subject to Debt

§ 1.752-1 Treatment of partnership liabilities.

. . .

(b) *Increase in partner's share of liabilities.* Any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, is treated as a contribution of money by that partner to the partnership.

(c) *Decrease in partner's share of liabilities.* Any decrease in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities by reason of the partnership's assumption of the individual liabilities of the partner, is treated as a distribution of money by the partnership to that partner.

. . .

(e) *Property subject to a liability.* If property is contributed by a partner to the partnership . . . and the property is subject to a liability of the transferor, the transferee is treated as having assumed the liability. . . .

(f) *Netting of increases and decreases in liabilities resulting from same transaction.* If, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities . . . and a decrease in the partner's share of the partnership liabilities . . . , only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership. Generally, the contribution to . . . a partnership of property subject to a liability . . . will require that increases and decreases in liabilities associated with the transaction be netted to determine if a partner will be deemed to have made a contribution . . . as a result of the transaction. . . .

(g) *Example.* The following example illustrates the principles of paragraphs (b), (c), (e), and (f) of this section.

Example 1. Property contributed subject to a liability; netting of increase and decrease in partner's share of liability. B contributes property with an adjusted basis of \$1,000 to a general partnership in exchange for a one-third interest in the partnership. At the time of the contribution, the partnership does not have any liabilities outstanding and the property is subject to a recourse debt of \$150 and has a fair market value in excess of \$150. After the contribution, B remains personally liable to the creditor and none of the other partners bears any of the economic risk of loss for the liability under state law or otherwise. Under paragraph (e) of this section, the partnership is treated as having assumed the \$150 liability. As a result, B's individual liabilities decrease by \$150. At the same time, however, B's share of liabilities of the partnership increases by \$150. Only the net increase or decrease in B's share of the liabilities of the partnership and B's individual liabilities is taken into account in applying section 752. Because there is no net change, B is not treated as having contributed money to the partnership or as having received a distribution of money from the partnership under paragraph (b) or (c) of this section. Therefore B's basis for B's partnership interest is \$1,000 (B's basis for the contributed property).

Questions re Contributing Property Subject to Debt

17. Beth purchased the real estate she will be contributing to the partnership for \$50,000; \$50,000 is still her basis in that real estate; and the value of the 25% partnership interest she will be receiving is \$100,000. When Beth purchased the property, she borrowed \$10,000 (of the \$50,000 she paid), using the property itself as collateral for the loan. The property will still be subject to the \$10,000 loan at the time Beth contributes it to the partnership. Beth will remain personally liable to the lender. Neither the partnership nor any of the other partners will have any personal liability to the lender. But the partnership (not Beth) will repay the loan. What is Beth's basis in her partnership interest?
- \$110,000 (the fair market value of the property).
 - \$100,000 (the value of Beth's interest in the partnership).
 - \$50,000 (Beth's \$50,000 basis in the property, increased by the \$10,000 liability the partnership has assumed from her, decreased by her \$10,000 individual liability that the partnership took over from her).
 - \$40,000 (Beth's \$50,000 basis in the property, decreased by her \$10,000 individual liability that the partnership took over from her).

Contributing Services

The tax treatment of those who contribute services to a partnership in return for an interest in the partnership turns out to be more complicated than the tax treatment of those who contribute cash or property. Look back at Section 721(a) on page 3 of this Study Guide, and you will see that the general non-recognition rule – that contributions to a partnership do not result in gains or losses to the contributing partner or to the partnership – applies only to contributions of “property.” Contributions of *services* may result in gains or losses, sooner or later. The question of *whether* they will, and if so, when, requires more information than we have, so far, about Doug’s contribution of his services to the partnership he is forming with Anne, Beth and Carl.

So far, we do not know whether Doug’s 25% interest in the partnership is a

- “capital interest,” so that Doug will have an ownership interest in the partnership’s assets, which even at the very start of the partnership will include the cash contributed by Anne, the real estate contributed by Beth, and the equipment contributed by Carl, as well as an interest in the partnership’s profits, or only a
- “profits interest,” so that Doug will not have an ownership interest in the partnership’s assets, but merely will have an interest in the partnership’s profits.

(Even for non-tax reasons, the difference will matter if the partnership goes out of business, having more assets than liabilities, so when it is dissolved, its assets are to be distributed only to those partners who have a capital interest in the partnership.)

We also don’t know yet whether Doug must work for the partnership for a particular length of time in order to get (or keep) his 25% interest, or whether he can quit at any time and keep his interest.

As you read the next assignment, pay attention to why it matters whether Doug

- will have a capital interest in the partnership or only a profits interest, and
- must work for the partnership for a particular length of time, in order to retain his interest.

Read (in Schwarz & Lathrope)

Pages 447-453

Internal Revenue Code and Regulations provisions re Contributions of Services

§ 61. Gross income defined

- (a) General definition. – Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
- (1) Compensation for services, including fees, commissions, fringe benefits, and similar items. . . .

§ 83. Property transferred in connection with performance of services

- (a) General rule. – If, in connection with the performance of services, property is transferred to any person . . . , the excess of–
- (1) the fair market value of such property . . . at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
 - (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. . . .

Reg. § 1.721-1 Nonrecognition of gain or loss on contribution.

- (b)(1) . . . The value of an interest in . . . partnership capital [i.e., assets, rather than just an interest in the partnership's income] . . . transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. . . .

Questions re Contribution of Services

There is a surprising amount of complexity and uncertainty in this area, giving how often people form partnerships that include partners whose only contributions are their services. Some questions, though, have simple answers. I think the following are among those.

18. Suppose that Doug will be receiving a 25% *capital* interest in the partnership, and that the partnership agreement is completely silent about how long he must work to retain that interest. (This means that Doug's interest will vest as soon as the partnership is formed. And if the partnership were to dissolve a week later, or if Doug were to withdraw from the partnership a week later, he would be entitled to 25% of the assets on hand at that time, including the cash, real estate and equipment contributed by the others.) What will the tax consequences be to Doug, at the formation of the partnership?
- a. He will have taxable income in an amount equal to 25% of the value of the partnership's assets, because of Code sections 61(a) and 83(a).
 - b. He will not have taxable income, because of Code section 721(a).

19. Will the partnership be able to take any business expense deductions as a result of the arrangement described in Question 18?
- No.
 - Yes. The partnership will be able to take business expense deduction for whatever amount is included in Doug's income.
20. What effect will the arrangement described in Question 18 have on the partnership's income and basis in its assets?
- None.
 - The partnership will have to recognize a gain on the transfer to Doug of his undivided interest in the partnership's real estate and equipment; but it will get a step-up in its basis for that property.
 - There is a split of opinion on this question. The "majority" view is "a" but others – including the IRS, according to a Proposed Regulation – is "b."
 - There is a split of opinion on this question. The "majority" view is "b" but others – including the IRS, according to a Proposed Regulation – is "a."
21. Suppose that Doug will be receiving a 25% *capital* interest in the partnership, and that the partnership agreement provides that his interest will not vest unless and until he remains a partner, and provides his services, for 3 years from formation of the partnership. What would the tax consequences be to Doug, at the formation of the partnership?
- He will have taxable income in an amount equal to 25% of the value of the partnership's assets at the time of the formation of the partnership, because of Code sections 61(a) and 83(a).
 - He will not have taxable income at the time of the formation of the partnership, because of Code section 83(a)(2); but 3 years later, when his interest vests, he will have taxable income.
 - He will not have taxable income, ever, because of Code section 721(a).
22. Suppose that Doug will be receiving a 25% *profits* interest in the partnership, and that the partnership agreement provides that he will continue to be entitled to 25% of the partnership's profits so long as he remains a partner and continues to work for the partnership. What will the tax consequences be to Doug, at the formation of the partnership?
- He will have taxable income in an amount equal to 25% of the value of the partnership's assets, because of Code sections 61(a) and 83(a).
 - He will not have taxable income, because of Code section 721(a).
 - He will not have taxable income, because of Revenue Procedure 93-27.

Deducting Start-Up Expenses

Read (in Schwarz & Lathrope)

Pages 453-454

Internal Revenue Code provision re Start-Up Expenses

§ 709. Treatment of organization and syndication fees

- (a) General rule. Except as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.
- (b) Deduction of organization fees
 - (1) Allowance of deduction.-If a partnership elects the application of this subsection (in accordance with regulations prescribed by the Secretary) with respect to any organizational expenses-
 - (A) the partnership shall be allowed a deduction for the taxable year in which the partnership begins business in an amount equal to the lesser of-
 - (i) the amount of organizational expenses with respect to the partnership, or
 - (ii) \$5,000*, reduced (but not below zero) by the amount by which such organizational expenses exceed \$50,000*, and
 - (B) the remainder of such organizational expenses shall be allowed as a deduction ratably over the 180-month period beginning with the month in which the partnership begins business.

[*Increased to \$10,000 and \$60,000 by the Small Business Act of 2010 for startup expenses incurred *during* 2010 (not before *or* after!)]

Questions re Deducting Start-Up Expenses

23. The partnership formed by Anne, Beth, Carl and Doug will incur \$10,000 in start-up expenses for legal, accounting and filing fees. How much of that amount may the partnership deduct for the year in which the partnership begins business?
- a. All \$10,000, because all of these expenses are ordinary and necessary business expenses.
 - b. None of the \$10,000, because the amount exceeds the \$5,000 cap on deductible start-up expenses.
 - c. \$5,000 of the \$10,000; the remaining \$5,000 must be deducted over 180 months (15 years!).

Study Guide 3

FORMING A BUSINESS

Forming a Corporation

Contributing Property

Contributing Services

Forming a Corporation

Suppose that Anne, Beth, Carl and Doug decide to form a corporation, rather than a partnership. Each of them will be contributing the same things to the corporation they would have contributed to the partnership:

- Anne will be contributing \$100,000 in cash;
- Beth will be contributing real estate for which she paid \$50,000 and in which her basis still is \$50,000;
- Carl will be contributing equipment for which he paid \$100,000, on which he took \$75,000 in depreciation deductions so his basis now is \$25,000; and
- Doug will be contributing his services.

As before, suppose that in return for their contributions, each of them will receive an equal interest in the corporation; that is, each will receive 25% of the corporation's stock. To make the arithmetic easy, let's assume that each share of stock is worth \$100, so each of them will receive 1,000 shares.

Recall again (from the Survey course) that section 1001 of the Internal Revenue Code requires recognition of gains (or losses) when they are realized as a result of sales or exchanges of property, unless some other section of the Code provides otherwise. The question to be considered now is whether the exchange of cash, real estate, equipment and services for stock in the corporation is taxable under Code section 1001, or whether some other section of the Code makes the exchange tax-free or tax-deferred.

Contributing Property

Read (in Schwarz & Lathrope)

Pages 121-126

Internal Revenue Code provisions & Treasury Regulations re Contributing Property

§ 351. Transfer to corporation controlled by transferor

- (a) General rule. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

§ 368(c) Control defined

For purposes of [§351 and some other sections], the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Reg. § 1.351-1(a)(1) Transfer to corporation controlled by transferor.

Section 351(a) provides, in general, for the nonrecognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock . . . in such corporation, if immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. . . . To be in control of the transferee corporation, such person or persons must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation (see section 368(c)). . . . The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

§ 1032. Exchange of stock for property

- (a) Nonrecognition of gain or loss. No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. . . .

Reg. § 1.1032-1(a) Disposition by a corporation of its own capital stock

- (a) The disposition by a corporation of shares of its own stock (including treasury stock) for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved. . . . A transfer by a corporation of shares of its own stock (including treasury stock) as compensation for services is considered, for purposes of section 1032(a), as a disposition by the corporation of such shares for money or other property.

Questions re Contributing Property

1. *If* Doug was *not* going to be a shareholder – if, instead, he was going to be a salaried employee – would the contributions of Beth and Carl to the corporation, in return for 33 1/3% of the corporation’s stock each, have resulted in taxable income to Anne, Beth and Carl?
 - a. Yes as to Beth and Carl, because under section 1001 they would be exchanging property having a basis of \$50,000 and \$25,000 respectively for stock having a value of \$100,000 each. Anne wouldn’t have taxable income, because she would be exchanging \$100,000 in cash for stock having a value of \$100,000, and thus she wouldn’t have realized any gain to be recognized.
 - b. No as to Beth and Carl, because they and Anne contributed property and cash solely in exchange for stock, and immediately thereafter, the three of them together owned 100% of the corporation’s stock. Under section 351(a), Beth and Carl did not recognize their gains; and Anne had no gain to recognize.
2. Question 1 does not state the deal that Anne, Beth, Carl and Doug actually made. Their deal is that Doug is not going to be a non-owner salaried employee; he is going to receive 25% of the corporation’s stock in return for his services. If they follow through with their actual deal, will Anne, Beth and Carl have to recognize taxable income?
 - a. Yes as to Beth and Carl, because under section 1001 they would be exchanging property having a basis of \$50,000 and \$25,000 respectively for stock that has a value of \$100,000 each. Section 351(a) wouldn’t apply, because immediately after the exchange, Anne, Beth and Carl would own only 75% of the stock, which is less than the 80% required by that section in order to avoid recognition of gain. Again, Anne wouldn’t have taxable income, because she would be exchanging \$100,000 in cash for stock having a value of \$100,000, and thus she wouldn’t have realized any gain to be recognized.
 - b. No as to Beth and Carl, because they and Anne contributed property and cash solely in exchange for stock, so under section 351(a), they did not recognize their gains; and Anne had no gain to recognize.
3. Suppose that Anne, Beth and Carl contribute cash, property and equipment in return for 33 1/3% of the corporation’s stock – 133 1/3 shares each – and then, after the corporation is formed, but pursuant to a pre-incorporation agreement with Doug, they each give Doug 33 1/3 shares in return for his promise to provide his services to the corporation. As a result of these transactions, each of the four of them will own 1000 shares, or 25%, of the corporation. But “immediately” after the corporation is formed, Anne, Beth and Carl will own 100% of the corporation. Under these circumstances, will Beth and Carl recognize gains as a result of their contributions of property and equipment?
 - a. No they will not recognize gains, because doing it this way satisfies section 351(a)’s requirement that “immediately” after the exchange, those who contributed property and cash own 100% of the corporation’s shares.
 - b. Yes they will have to recognize gain, because even though section 351(a) appears to be satisfied, the 80% control test will be applied after the transfer to Doug, at which time, Anne, Beth and Carl will own only 75% of the stock.

4. As a result of which of the transactions described above will the *corporation* have taxable income as a result of the contributions of the shareholders?
- The transaction described in Question 1.
 - The transaction described in Question 2.
 - The transaction described in Question 3.
 - The corporation will not have taxable income in connection with any of the transactions described in Questions 1, 2, and 3.

Contributing Services

So far, we haven't said anything about the tax consequences *to Doug* as a result of his contribution of services to the corporation in return for his 25% of its stock. We saw that if Doug receives 25% of the stock in exchange for his services, it "messes things up" (a technical term) for Beth and Carl. Now we'll look at what the tax consequences are to Doug himself. And we'll see whether there's any way to do this deal that "cleans things up" (another technical term) for Beth and Carl.

Read (in Schwarz & Lathrope)

Pages 126-128

Internal Revenue Code & Treasury Regulation provisions re Contributing Services

§ 351. Transfer to corporation controlled by transferor

- (a) General rule. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation. . . .
- (d) Services . . . not treated as property. For purposes of this section, stock issued for –
 - (1) services . . . shall not be considered as issued in return for property.

Reg. § 1.351-1(a)(1) Transfer to corporation controlled by transferor.

. . .

For purposes of this section-

- (i) Stock . . . issued for services rendered or to be rendered to or for the benefit of the issuing corporation will not be treated as having been issued in return for property, and
- (ii) Stock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who transferred such property, shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property.

§ 83. Property transferred in connection with performance of services

- (a) General rule. – If, in connection with the performance of services, property is transferred to any person . . . , the excess of–
 - (1) the fair market value of such property . . . , over
 - (2) the amount (if any) paid for such property,shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture. . . .
- (b) Election to include in gross income in year of transfer. –
 - (1) In general. – Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income for the taxable year in which such property is transferred, the excess of–
 - (A) the fair market value of such property at the time of transfer . . . , over
 - (B) the amount (if any) paid for such property.If such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.
-
- (c) Special rules. – For purposes of this section–
 - (1) Substantial risk of forfeiture. – The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

Questions re Contributing Services

5. Will there be any tax consequences to Doug on account of his receiving 25% of the stock of the corporation, worth \$100,000, in return for the services he will be performing?
 - a. No, section 351(a) treats his services the same way it treats cash and property, so he will not have to recognize any gain as a result of his receipt of the stock.
 - b. Yes, services are not property, and thus 351(a) will not apply to his receipt of stock. As a result, Doug will have to pay tax on the value of his stock.
6. If you determined that the answer to Question 5 is "b," when, exactly, will Doug have to pay that tax, and what amount will he have to recognize as taxable income?
 - a. He will have to include \$100,000 (the value of the stock) in his taxable income for the year in which he receives the stock, *if* the stock is *not* restricted (i.e., is not subject to a risk of forfeiture).
 - b. If the stock is restricted, he will have to include the value of the stock *at the time the restriction expires* in his taxable income *for the year in which the restriction expires*, unless he chooses to pay tax immediately even though the stock is restricted, in which case, he'll have to include \$100,000 in his taxable income for the year he receives the stock.
 - c. Both "a" and "b" are correct.
7. Suppose that instead of Doug receiving all 1,000 shares of stock for services, he pays \$10,000 for 100 shares and receives 900 shares (worth \$90,000) in return for services. Under these circumstances, will Beth and Carl recognize gain as a result of their contributions of property and equipment?
 - a. No, because the tax consequences to Beth and Carl have nothing to do with the amount of stock that Doug buys for cash.
 - b. Yes, Beth and Carl will have to recognize their gains, because section 351(a) will not apply. It won't apply, because even if Doug pays cash for 100 shares, Doug, Anne, Beth and Carl will have exchanged property or cash for just 3,100 shares (1,000 each to Anne, Beth and Carl, plus 100 to Doug) which is less than 80% of the 4000 shares that will be issued in total.
 - c. No, Beth and Carl will not have to recognize their gains, because
 - the \$10,000 Doug will pay for 100 shares is more than 10% of the \$90,000 worth of stock he'll be receiving for services, and thus
 - the cash he pays for those 100 shares is *not* "relatively small" in value compared to the 900 shares of stock he'll receive for services, and therefore
 - all 1,000 shares Doug will receive will be counted when applying the 80% control test, and thus
 - the 80% control test will be satisfied (indeed, 100% of control will be in hands of Anne, Beth, Carl and Doug), and therefore
 - section 351(a) will apply.
- 7a. What result would you get if Doug purchased fewer than 100 shares?

More on the Contribution of Property: Disproportionate Contributions

Earlier, we decided that if Anne pays \$100,000 for her 25% of the company, that necessarily means that the property that Beth contributes also has a value of \$100,000, and so does the equipment that Carl contributes and the services that Doug contributes. This is true *if* Anne, Beth, Carl and Doug are making this deal in an arms-length negotiation. It is possible, of course, that someday you may have clients who are not at arms-length from one another. They may be related by blood or marriage, or one may owe money to the other. For example, if Anne is Beth's mother, Anne may want to give Beth a gift; Anne could do that by paying \$100,000 in cash for a 25% interest in the company, and allowing Beth to contribute property worth less than \$100,000 in return for an equal 25% interest. Likewise, Anne may owe money to Carl. Anne could repay Carl by allowing him to contribute equipment worth less than \$100,000 in return for his equal 25% interest in the business. We'll now consider what the tax consequences of these circumstances may be.

Read (in Schwarz & Lathrope)

Page 129 (paragraph b)

Internal Revenue Code provisions & Treasury Regulations re Contributing Property

Reg. § 1.351-1(b) Transfer to corporation controlled by transferor.

(1) Where property is transferred to a corporation by two or more persons in exchange for stock . . . , it is not required that the stock . . . received by each be substantially in proportion to his interest in the property immediately prior to the transfer. However, where the [shares of] stock . . . received are received in disproportion to such interest, the entire transaction will be given tax effect in accordance with its true nature, and in appropriate cases the transaction may be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts . . . , to pay compensation . . . , or to satisfy obligations of the transferor of any kind.

(2) The application of paragraph (b)(1) of this section may be illustrated as follows:

Example (1). Individuals A and B, father and son, organize a corporation with 100 shares of common stock to which A transfers property worth \$8,000 in exchange for 20 shares of stock, and B transfers property worth \$2,000 in exchange for 80 shares of stock. No gain or loss will be recognized under section 351. However, if it is determined that A in fact made a gift to B, such gift will be subject to [gift] tax. . . . Similarly, if B had rendered services to A (such services having no relation to the assets transferred or to the business of the corporation) and the disproportion in the amount of stock received constituted the payment of compensation by A to B, B will be taxable upon the fair market value of the 60 shares of stock received as compensation for services rendered, and A will realize gain or loss upon the difference between the basis to him of the 60 shares and their fair market value at the time of the exchange.

Example (2). Individuals C and D each transferred, to a newly organized corporation, property having a fair market value of \$4,500 in exchange for the issuance by the corporation of 45 shares of its capital stock to each transferor. At the same time, the corporation issued to E, an individual, 10 shares of its capital stock in payment for organizational and promotional services rendered by E for the benefit of the corporation. E transferred no property to the corporation. C and D were under no obligation to pay for E's services. No gain or loss is recognized to C or D. E received compensation taxable as ordinary income to the extent of the fair market value of the 10 shares of stock received by him.

Questions re Disproportionate Contributions of Property

8. Suppose that Anne is Beth's mother, and that Anne will be making a gift to Beth by: contributing \$100,000 to the corporation in return for 1,000 shares of its stock; and by agreeing that Beth may have 1,000 shares of stock too, in return for Beth's contribution of real estate worth just \$75,000, in which Beth has a basis of \$50,000. Would Beth have to recognize a gain as a result of her contribution to the corporation?
- Yes, Beth would have to recognize a gain, because under these circumstances, section 351 would not apply.
 - No, Beth would not have to recognize a gain, because even under these circumstances, section 351 still applies. However, Anne would have to pay a gift tax in connection with the formation of the corporation, because the "true nature" of the transaction is that Anne made a gift to Beth.
9. If your answer to Question 8 was "b", how much of a gift did Anne make to Beth?
- \$25,000, which is the difference between the \$100,000 value of the 1,000 shares Beth received and the value of the property Beth contributed.
 - \$12,512.50, which is the value the 143 shares Anne gave to Beth, calculated this way: 2,000 shares of stock will be issued to Anne and Beth in return for \$100,000 in cash and property worth \$75,000, i.e., for a total of \$175,000, which makes each share worth \$87.50 ($\$175,000/2,000 = \87.50). Therefore, Anne will be treated by the law as having originally received 1,143 shares ($\$100,000/\$87.50 = 1,143$); and Beth will be treated as having originally received 857 shares ($\$75,000/\$87.50 = 857$). Then, the law will presume that Anne transferred 143 shares to Beth (so that each of them winds up with 1,000 shares). And those 143 shares are worth \$12,512.50 ($\$87.50 \times 143 = \$12,512.50$).

10. Suppose that Anne owes Carl money for equipment she previously rented from him (which she returned but hasn't yet paid for), and that she is going to pay him for that equipment by: contributing \$100,000 to the corporation in return for 1,000 shares of its stock; and by agreeing that Carl may have 1,000 shares of stock too, in return for Carl's contribution of equipment worth just \$75,000. If Carl's basis in the equipment he will be contributing is \$25,000, will Carl have to recognize a gain as a result of his contribution to the corporation?
- Yes, Carl will have to recognize a gain, because under these circumstances, section 351 will not apply.
 - No, Carl would not have to recognize a gain, because even under these circumstances, section 351 still applies. However, Carl will have taxable income anyway in connection with the formation of the corporation, because the "true nature" of the transaction is that Anne paid Carl for the use of his equipment. Likewise, *if* Anne had previously rented the equipment for *business* purposes, she would have a tax deduction, for the same reason Carl would have income.
11. If your answer to Question 10 was "b", how much income did Carl have?
- \$75,000, which is the difference between the \$100,000 value of the 1,000 shares he received and his \$25,000 basis in the property he contributed.
 - \$12,512.50, calculated as in answer "b" to Question 9.
12. Does it matter to Doug whether Anne is making a gift to Beth and paying a debt to Carl by allowing them to have 1,000 shares of stock in the corporation, so long as Doug receives 1,000 shares too (and he's going to pay tax on his shares the year he receives them, either because they aren't restricted, or because he elects to take their value into income the year he receives them even though they are restricted)?
- No, it doesn't matter to Doug, because he's going to have \$100,000 in income on account of his 1,000 shares, regardless of how or why Beth and Carl got their shares.
 - Yes, it matters to Doug, because his 1,000 shares won't really be worth \$100,000 – and thus he won't have \$100,000 in income – if Beth contributed property worth less than \$100,000 and Carl contributed equipment that's worth less than \$100,000.
- 12a. If your answer to Question 12 was "b", how much income would Doug have?

More on the Contribution of Property: Basis and Holding Period

Basis and holding period are not very exciting concepts. But they are important. Some day, Anne, Beth, Carl and Doug will want to sell or exchange their shares in the corporation. When that day comes (towards the end of this semester), they will have to be able to compute their "gains" or "losses." In order to do that, each of them will have to know what his or her basis is in the stock he or she owns. And if they have a taxable gain, they'll need to know whether they can take advantage of lower-than-ordinary capital gains rates – something they'll be able to do only if the holding period for their shares is more than a year. The corporation too needs to know its basis in the real estate contributed by Beth and equipment contributed by Carl, if the corporation ever sells or exchanges the property or equipment. And basis is important, because it affects whether distributions by the corporation to its shareholders are "income" to those shareholders, or not (something we'll consider in Study Guide 13).

Internal Revenue Code provisions re Basis and Holding Period

§ 358. Basis to distributees

(a) General rule. In the case of an exchange to which section 351. . . applies -

(1) Nonrecognition property

The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged. . . .

§ 362. Basis to corporations

(a) Property acquired by issuance of stock . . .

If property was acquired . . . by a corporation -

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, ...

then the basis shall be the same as it would be in the hands of the transferor. . . .

§ 1223. Holding period of property

For purposes of this subtitle -

(1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and . . . the property exchanged at the time of such exchange was a capital asset as defined in section 1221 [i.e., most types of property] or property described in section 1231 [i.e., trade or business property].

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

You should be able to get the general gist of the Code sections concerning "basis" and "holding period." If the sections aren't perfectly clear, that may be because they are a little ambiguous about who, exactly, they refer to and what "property" they refer to. See if this helps:

- The "distributee" referred to in the title of section 358 is the person to whom shares of stock are issued in return for that person's contribution of property; and the "property permitted to be received . . . without the recognition of gain or loss" is the stock received by that person.
- The "property . . . acquired . . . by a corporation" referred to in section 362 is the property contributed in exchange for stock.
- The "taxpayer" referred to in section 1223(1) is the shareholder; the "property received in an exchange" is the stock the shareholder received; and "the property exchanged" is the property contributed by the shareholder.

- The “taxpayer” referred to in section 1223(2) is the corporation; the “property . . . acquired” is the property contributed by the shareholder; and the “other person” is the shareholder who contributed the “property . . . acquired.”

Note: Later in the semester, when we get to Study Guide 12, we will see that *C corporations* pay tax on their long-term capital gains at the same rate as ordinary income (not at lower rates). So, at first blush, corporations don’t seem to benefit from section 1223(2)’s “transferred” or “carry-over” holding period for property contributed by shareholders. Indeed, *C corporations* do not receive any benefit from 1223(2). However, section 1223(2) does benefit shareholders of an *S corporation*, because the profits of an *S corp* are taxed to its shareholders, not to the corporation itself; and *S corp* shareholders pay tax on long-term capital gains at lower rates than on ordinary income.

Questions re Basis and Holding Period

Beth’s basis in the real estate she contributed to the corporation is \$50,000; and she had owned the real estate for two years by the time she contributed it.

13. On the day Beth received her 1,000 shares in the corporation, what was her basis in the stock, and what was her holding period in that stock?
 - a. Her basis in the stock was \$50,000, and her holding period was two years.
 - b. Her basis in the stock was \$50,000, and her holding period was one day.
 - c. Her basis in the stock was \$100,000 (the value of the stock she received, assuming that no part of the stock was a gift from Anne); and her holding period was two years.
 - d. Her basis in the stock was \$100,000 (the value of the stock she received, assuming that no part of the stock was a gift from Anne); and her holding period was one day.
14. On the day the corporation received real estate from Beth, what was the corporation’s basis in the real estate, and what was its holding period in that real estate?
 - a. The corporation’s basis in the real estate was \$50,000, and its holding period was two years.
 - b. The corporation’s basis in the real estate was \$50,000, and its holding period was one day.
 - c. The corporation’s basis in the real estate was \$100,000 (the value of the stock Beth received, assuming that no part of the stock was a gift from Anne); and its holding period was two years.
 - d. The corporation’s basis in the real estate was \$100,000 (the value of the stock Beth received, assuming that no part of the stock was a gift from Anne); and its holding period was one day.

15. On the day Doug received his 1,000 shares in the corporation, what was his basis in the stock, and what was his holding period in that stock?
- a. His basis in the stock was \$100,000, because that is the amount he had to include in income when he received the stock, and his holding period was one day, because he contributed services which are not property so he couldn't have a holding period in them.
 - b. His basis in the stock was \$0, because that is the amount he paid for his stock, and his holding period was one day, because he contributed services which are not property so he couldn't have a holding period in them.

More on the Contribution of Property: Treatment of Boot

So far, we've assumed that the property contributed by Beth and the equipment contributed by Carl are worth \$100,000 each (or less, if Anne wanted to make a gift and repay a debt to them). Suppose, though, that the parties agree that Beth's property is worth \$110,000 and Carl's property is worth \$120,000. If despite this disparity in the value of their contributions, the parties still want each of them to own 25% of the corporation, they could do this:

- Anne will contribute \$100,000 for 1,000 shares;
- Beth will contribute real estate worth \$110,000 in exchange for 1,000 shares plus \$10,000 in cash (paid by the corporation out of the money contributed by Anne),
- Carl will contribute equipment worth \$120,000 in exchange for 1,000 shares plus \$20,000 in cash (paid by the corporation out of the money contributed by Anne), and
- Doug will contribute his services, valued by the parties at \$100,000.

After doing this, the corporation will have \$70,000 on hand (having paid out \$30,000 to Beth and Carl), so \$70,000 better be enough for start-up operations. That, though, is a business matter. The tax issue is whether doing it this way creates any tax complications, especially for Beth and Carl.

Read (in Schwarz & Lathrope)

Page 132-137

Internal Revenue Code provisions re Boot

§ 351. Transfer to corporation controlled by transferor

- (a) General rule. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.
- (b) Receipt of property
If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under subsection (a), other property or money, then -
 - (1) gain (if any) to such recipient shall be recognized, but not in excess of -
 - (A) the amount of money received. . . .

§ 358. Basis to distributees

- (a) General rule. In the case of an exchange to which section 351. . . applies -
 - (1) Nonrecognition property
The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged -
 - (A) decreased by - . . .
 - (ii) the amount of any money received by the taxpayer . . .
 - (B) increased by - . . .
 - (ii) the amount of gain to the taxpayer which was recognized on such exchange.

§ 362. Basis to corporations

- (a) Property acquired by issuance of stock . . .
If property was acquired . . . by a corporation -
(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, ... then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

Questions re Boot

16. If Beth's basis in her real estate is \$50,000, but the real estate is worth \$110,000, so she contributes it to the corporation in return for 1,000 shares and \$10,000 in cash, will she realize a gain that she has to recognize, and if so, how much of a gain will she have to recognize?
- No, she will not realize a gain, because she will be receiving only \$10,000 in cash in exchange for property in which her basis is \$50,000.
 - Yes, she will realize a \$60,000 gain (which is the difference between her \$50,000 basis, and the \$110,000 in stock and cash that she will be receiving); but she won't have to recognize any of that gain because of section 351(a).
 - Yes, she will realize a \$60,000 gain (which is the difference between her \$50,000 basis, and the \$110,000 in stock and cash that she will be receiving); but she will have to recognize only \$10,000 of that gain because section 351(b) requires her to recognize her gain up to the amount of cash she receives (in addition to her stock).
17. What will Beth's basis be in the 1,000 shares she will receive?
- \$10,000, which is the amount of cash she received.
 - \$50,000, which is her basis in the property she will contribute, less the \$10,000 in cash she received plus the \$10,000 in gain she will have to recognize.
 - \$100,000, which is the value of the property she will contribute, less the amount of cash she will receive.
 - \$110,000, which is the value of the property she will contribute.
18. What is the corporation's basis in the real estate it will receive from Beth?
- \$10,000, which is the amount of cash it will pay Beth.
 - \$50,000, which is Beth's basis in the property she will contribute, less the \$10,000 in cash the corporation will pay her, plus the \$10,000 in gain she will have to recognize.
 - \$60,000, which is Beth's basis in the property she will contribute, plus the \$10,000 in gain she will have to recognize.
 - \$110,000, which is the value of the property the corporation will receive from Beth.

The tax consequences to Carl will be the same as the consequences to Beth, with two exceptions.

- Carl will be getting \$20,000, rather than \$10,000; so whatever you did about Beth's \$10,000, do it now with respect to Carl's \$20,000.
- Carl took depreciation on his equipment (where Beth did not), so although all of Beth's gain will be taxed at capital gains rates, Carl will have to recapture the depreciation he took (up to the amount of his taxable gain).

Study Guide 4

FORMING A BUSINESS

Forming a Corporation

Contributing Property
Incorporating a Going Business

Forming a Corporation

Contributing Property

Corporation's Assumption of Shareholder's Liabilities

Read (in Schwarz & Lathrope)

Pages 137-139 (through the end of paragraph "a")

Internal Revenue Code provisions re Assumption of Shareholder's Liabilities

§ 357. Assumption of liability

- (a) General rule. Except as provided in subsections (b) and (c), if -
 - (1) the taxpayer receives property which would be permitted to be received under section 351 . . . without the recognition of gain if it were the sole consideration, and
 - (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer,
then such assumption shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351. . . .
- (b) Tax avoidance purpose
 - (1) In general. If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in subsection (a) -
 - (A) was a purpose to avoid Federal income tax on the exchange, or
 - (B) if not such purpose, was not a bona fide business purpose,then such assumption (in the total amount of the liability assumed pursuant to such exchange) shall, for purposes of section 351 . . . be considered as money received by the taxpayer on the exchange. . . .
- (c) Liabilities in excess of basis
 - (1) In general. In the case of an exchange -
 - (A) to which section 351 applies . . . if the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

§358. Basis to distributees

(d) Assumption of liability

- (1) In general. Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer, such assumption shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

Questions re Assumption of Shareholder's Liabilities

1. Beth purchased the real estate she will be contributing to the corporation for \$50,000; \$50,000 is still her basis in that real estate; and the value of the 1,000 shares she will be receiving (which are 25% of all shares to be issued) is \$100,000. When Beth purchased the property, she borrowed \$10,000 (of the \$50,000 she paid), using the property itself as collateral for the loan. The property will still be subject to the \$10,000 loan at the time Beth contributes it to the corporation. Beth will remain personally liable to the lender. Neither the corporation nor any of the other shareholders will have any personal liability to the lender. But the corporation (not Beth) will repay the loan. What are the tax consequences to Beth (if Beth is not seeking to avoid taxes) by doing it this way)?
 - a. The \$10,000 liability assumed by the corporation will be taxable income – called “boot” – to Beth, because this transaction is equivalent to the corporation giving her 1,000 shares of its stock plus \$10,000 in cash that she uses to pay off the loan.
 - b. Beth will not have to recognize any gain at all, because under section 357(a), the corporation's assumption of the \$10,000 liability does not prevent Beth's contribution of the property from being tax-free under section 351.
2. Given the facts in Question 1, what is Beth's basis in her stock in the corporation?
 - a. \$110,000 (the fair market value of the property).
 - b. \$100,000 (the value of Beth's stock in the corporation).
 - c. \$50,000 (Beth's basis in the property).
 - d. \$40,000 (Beth's \$50,000 basis in the property, decreased by the \$10,000 liability that the corporation took over from her).

3. You'll recall that Carl will be contributing equipment worth \$100,000, on which he took \$75,000 in depreciation deductions, so his basis now is \$25,000. Previously, nothing was said about how much Carl paid for that equipment or how he paid for it when he acquired it in the first place. Suppose that Carl:
- paid \$175,000 for the equipment, \$75,000 of which was his own money and a \$100,000 of which he borrowed,
- and by the time he contributes the equipment to the corporation, he
- has repaid \$50,000 of the loan, leaving a loan balance of \$50,000, and
 - has taken \$150,000 in depreciation deductions, which is why his basis is \$25,000.
- Suppose too that the corporation will be assuming the balance of Carl's \$50,000 loan (which means that the equipment now is really worth \$150,000, which is why its net value to the corporation is \$100,000, and why Carl will be receiving 1,000 shares of stock worth \$100,000 for it). What are the tax consequences to Carl (if Carl is not seeking to avoid taxes) by doing it this way?
- a. The \$50,000 liability assumed by the corporation will be taxable income – called “boot” – to Carl, because this transaction is equivalent to the corporation giving him 1,000 shares of its stock plus \$50,000 in cash that he uses to pay off the loan.
 - b. Carl will not have to recognize any gain at all, because under section 357(a), the corporation's assumption of the \$50,000 liability does not prevent Carl's contribution of the property from being tax-free under section 351.
 - c. Carl will have \$25,000 in taxable income, because \$25,000 is the amount by which the \$50,000 loan assumed by the corporation exceeds his \$25,000 basis in the equipment; and despite section 351's general “no recognition” rule, section 357(c) requires the recognition of some gain when, as here, the liability assumed exceeds the taxpayer's basis in the property he or she contributes.
4. Given the facts in Question 3, what is Carl's basis in his stock in the corporation?
- a. \$100,000 (the value of Carl's stock in the corporation).
 - b. \$25,000 (Carl's basis in the property).
 - c. -\$25,000 (Carl's \$25,000 basis in the property, decreased by the \$50,000 liability that the corporation took over from him).
 - d. \$0 (Carl's \$25,000 basis in the property, decreased by the \$50,000 liability that the corporation took over from him, increased by the \$25,000 in gain he had to recognize).

Incorporation of a Going Business

Read (in Schwarz & Lathrope)

Page 144-145

Questions re Incorporation of a Going Business

5. The equipment contributed by Carl was previously used by him in connection with his operation of a going business. All that remains of that business, apart from the equipment, is \$10,000 in accounts receivable (i.e., amounts that Carl's former customers still owe him) which he has not yet reported as income, and \$10,000 in accounts payable (i.e., as-yet unpaid bills) which he has not yet deducted. If Carl contributes both the receivables and the payables to the corporation – in exchange for no additional stock, because the net value of these items is \$0 – what would the tax consequences to him be?
- Carl will have \$10,000 in income when the corporation collects the receivables, because the assignment-of-income doctrine will prevent him from assigning his income to the corporation; he will not be able to deduct the payables when the corporation pays them, because he won't have paid them; he will have an additional \$10,000 in income when the corporation pays his bills; and the corporation may not be able to deduct the payments because they will not be the corporation's own expenses (unless it categorizes the payments as compensation to Carl).
 - Carl will not have income from the assignment of his receivables, and the corporation will be able to deduct the payments when it makes them.

Contributions to Capital

Read (in Schwarz & Lathrope)

Page 145-146

Internal Revenue Code provisions & Treasury Regulations re Contributions to Capital

§ 118. Contributions to the capital of a corporation

- (a) General rule. In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

Reg. § 1.118-1 Contributions to the capital of a corporation.

In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. . . .

Questions re Contributions to Capital

Anne, Beth, Carl and Doug recognize that \$100,000 may not be enough cash to sustain the corporation's operations until it becomes profitable, and that someday the company may need more money. As a result, they have agreed that if the corporation needs more cash, Anne will contribute as much as an additional \$100,000, in return for the corporation's issuing to her one additional share of stock for each \$100 she contributes. This of course would mean that Anne would own more than 25% of the corporation, while the other three each would own less than 25%. So they also agreed that if additional cash becomes necessary, Beth, Carl and Doug may contribute additional cash too, if they are willing and able to do so; and if they do, they too will receive one additional share from the corporation for each \$100 they contribute. Finally, they agreed that if all four contribute equal amounts of additional cash, no additional stock will be issued, because each of the four will wind up with 25% of the corporation, as before.

6. If Anne contributes an additional \$100,000, and the corporation issues an additional 1,000 shares to her, and none of the others contribute anything (so she owns 2,000 shares or 40% of the corporation, while the others own 1,000 shares or 20% each), what are the tax consequences to the corporation?
 - a. The corporation will have taxable income of \$100,000.
 - b. The corporation will have taxable income of some other amount. (How much?)
 - c. The corporation will not have taxable income at all.
7. If Anne, Beth, Carl and Doug each contribute an additional \$25,000, so no additional stock is issued, what are the tax consequences to the corporation?
 - a. The corporation will have taxable income of \$100,000.
 - b. The corporation will have taxable income of some other amount. (How much?)
 - c. The corporation will not have taxable income at all.
8. If Anne, Beth, Carl and Doug each contribute an additional \$25,000, so no additional stock is issued, what effect will that have on the basis each of them has in the stock that was issued to them when the corporation was first formed?
 - a. It has no effect at all. Their basis that each has in his or stock will remain what it was originally.
 - b. The basis of each of them will increase by \$25,000.

Study Guide 5

FORMING A BUSINESS

Forming a Corporation

Capitalizing with Debt
Deducting Organizational and Start-Up Expenses

Forming a Corporation

Capitalizing with Debt

So far, we have assumed that Anne would receive stock for her \$100,000 cash investment. As a matter of corporate law, however, Anne isn't limited to a cash-for-stock or nothing-at-all choice. She could, for example, contribute \$50,000 in cash for stock, and could lend the corporation \$50,000 in return for a promissory note (or something fancier like a bond or debenture). If Beth, Carl and Doug were going to receive only stock for their contributions, Anne's \$50,000 loan might result in her receiving less stock than Beth, Carl and Doug. But if that's a problem, Beth, Carl and Doug could receive notes and stock for their contributions too, so that the ownership interests of all four were the same.

There are *non-tax* reasons why Anne and the others may want to be creditors of the corporation for part of their investments, rather than shareholders for all it. There also are some very important *tax* reasons for their wanting to do so.

Questions re Capitalizing with Debt

The following questions are answered in the assigned pages of Schwarz & Lathrope and in the Code sections below. Read the questions first, so you'll know what to watch for as you study the book and Code. When you answer the questions, be sure to make a note to yourself about where you found your answers.

1. If Anne lends the corporation \$50,000 (and contributes the other \$50,000 for stock), will the payments the corporation makes to her in repayment of her loan be taxed to her in the same way as the dividends the corporation pays her on her stock?
 - a. Yes, all payments made by the corporation to Anne will be taxed to her in the same fashion.
 - b. No. The interest the corporation pays to Anne on her loan will be taxed to her at ordinary income tax rates. The principal repayments the corporation pays to her on her loan will not be taxed to her at all. And the dividends the corporation pays to her on her stock will be taxed to her at capital gains rates.

2. If Anne lends the corporation \$50,000 (and contributes the other \$50,000 for stock), will the tax consequences to the corporation of the payments it makes to her in repayment of her loan be the same as the tax consequences of the dividends the corporation pays her on her stock?
 - a. Yes, the tax consequences of all payments made by the corporation to Anne will be the same to the corporation.
 - b. No. The corporation will be able to deduct the interest it pays to Anne on her loan. But the corporation will not be able to deduct the principal repayments it makes to her on her loan, nor will it be able to deduct the dividends it pays to her on her stock.
3. Suppose that Beth, Carl and Doug also received \$50,000 notes (and \$50,000 in stock) for their contributions to the corporation. Would the formation of the corporation be tax-free as to them, or would their receipt of notes require them to recognize income?
 - a. Section 351 would still apply, so it would be tax-free to all of them.
 - b. Section 351 would still apply to Beth and Carl; but the notes would be "boot" to them, so they would have to recognize up to \$50,000 of their gains. Section 351 never applied to Doug, so he would have to recognize \$100,000 in gain, as before.
4. If Anne lends \$50,000 to corporation, and contributes \$50,000 in exchange for stock, how likely is it that the IRS will seek to reclassify her loan as equity?
 - a. Unlikely.
 - b. Likely, especially if the contributions of Beth, Carl and Doug also are characterized as \$50,000 loans and \$50,000 contributions for stock.
 - c. More information is necessary to answer this question. (What information?)

Read (in Schwarz & Lathrope)

Pages 152-161

Schwarz & Lathrope explain that the question of whether investments characterized as "debt" really constitute "equity" was supposed to have been addressed in Regulations that Treasury has never adopted. As a result, the factors to be applied in deciding whether debt really is equity are factors that were recommended to Treasury by Congress in section 385 (which says "factors . . . may include"), as well as factors applied by judges. The factors recommended by Congress and those used by judges are similar but not identical, so I have not reproduced section 385 below. The description in Schwarz & Lathrope is quite good, and certainly good enough to answer the questions above.

Deducting Start-Up and Organizational Expenses

Questions re Start-Up and Organizational Expenses

The following question is answered in the assigned pages of Schwarz & Lathrope and in the Code sections below. Read the question first, so you'll know what to watch for as you study the book and Code. When you answer the question, be sure to make a note to yourself about where you found your answer.

5. The corporation formed by Anne, Beth, Carl and Doug will incur \$10,000 in expenses for legal, accounting and filing fees. How much of that amount may the corporation deduct for the year in which the corporation begins business?
 - a. All \$10,000, because all of these expenses are ordinary and necessary business expenses.
 - b. None of the \$10,000, because the amount exceeds the \$5,000 cap on deductible start-up expenses.
 - c. \$5,000 of the \$10,000; the remaining \$5,000 must be deducted over 180 months (15 years!).

Read (in Schwarz & Lathrope)

Pages 148-149

Internal Revenue Code provisions and Regulations re Deducting Organizational and Start-Up Expenses

§ 195. Start-up expenditures

- (a) Capitalization of expenditures. Except as otherwise provided in this section, no deduction shall be allowed for start-up expenditures.
- (b) Election to deduct
 - (1) Allowance of deduction.-If a taxpayer elects the application of this subsection with respect to any start-up expenditures-
 - (A) the taxpayer shall be allowed a deduction for the taxable year in which the active trade or business begins in an amount equal to the lesser of-
 - (i) the amount of start-up expenditures with respect to the active trade or business, or
 - (ii) \$5,000, reduced (but not below zero) by the amount by which such start-up expenditures exceed \$50,000, and
 - (B) the remainder of such start-up expenditures shall be allowed as a deduction ratably over the 180-month period beginning with the month in which the active trade or business begins.

...

- (c) Definitions. For purposes of this section -
- (1) Start-up expenditures. The term "start-up expenditure" means any amount -
 - (A) paid or incurred in connection with -
 - (i) investigating the creation or acquisition of an active Trade or business, or
 - (ii) creating an active trade or business, or
 - (iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and
 - (B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

§ 248. Organizational expenditures

- (a) Election to Deduct.-If a corporation elects the application of this subsection . . . with respect to any organizational expenditures--
- (1) the corporation shall be allowed a deduction for the taxable year in which the corporation begins business in an amount equal to the lesser of-
 - (A) the amount of organizational expenditures with respect to the taxpayer, or
 - (B) \$5,000, reduced (but not below zero) by the amount by which such organizational expenditures exceed \$50,000, and
 - (2) the remainder of such organizational expenditures shall be allowed as a deduction ratably over the 180-month period beginning with the month in which the corporation begins business.
- (b) Organizational expenditures defined. The term "organizational expenditures" means any expenditure which -
- (1) is incident to the creation of the corporation;
 - (2) is chargeable to capital account; and
 - (3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

Study Guide 6

OPERATING A BUSINESS

Operating a Partnership

Taxing Partnership Operations

OPERATING A BUSINESS

We now begin a series of classes in which we'll look at the tax rules that apply to the operations of entities, once they've been formed and are doing business. These rules are important, of course, during the entire lives of entities. But they're also important at the pre-formation stage, because the ways in which different types of business entities are taxed on their operations could very well influence which type of entity clients select for their new businesses in the first place.

For example, during the heyday of tax shelters, limited partnerships were the entity of choice, precisely because partnership losses are passed through to partners who (back in those days) were able to deduct those losses against their income from other sources. That result would not have been possible with C corporations. Tax shelters are now largely gone. But it still is the case that for some investors and some types of businesses, the tax treatment of one type of entity will be far more desirable than the tax treatment of other types of entities. The time to realize this is before the entity is formed, not afterward.

We'll look first at the principal tax aspects of operating partnerships. I say "principal" tax aspects, because partnerships lend themselves especially well to creative tax planning, and Congress and the Treasury have responded with countless rules designed to prevent taxpayers from abusing the system. Our hypothetical clients – Anne, Beth, Carl and Doug – are forming an entity for the purpose of running a business, not for the purpose of evading taxes. So although they don't want to pay more taxes than they must, neither will they be engaging in transactions that are designed solely to avoid tax.

Operating a Partnership

Taxing Partnership Operations

The general tax rule concerning the operations of partnerships is easily stated and understood: partnerships file tax returns, but they do not pay taxes themselves; their individual partners report and pay taxes on their individual shares of partnership profits. I'm sure it won't surprise you to learn that in practice, that general rule is implemented in ways that are a bit more complex.

Determining Profits and Losses at the Partnership Level

Questions re Determining Profits and Losses at the Partnership Level

As you read the assignment and Code sections below, watch for the answers to these questions:

1. Anne, Beth, Carl and Doug expect their business to lose a little money the first year, and hope it will become profitable the second. The business will have income from very ordinary sources (the sale of manufactured goods or goods purchased at wholesale; or something like that) and it will have only a handful of categories of expenses, also very ordinary. If allowed to do so, the business could easily keep track of its income and expenses using an off-the-shelf computer program (like Quicken), running on a \$400 computer. For the first couple of years, Anne, Beth, Carl and Doug would like to keep things as simple as possible. If they form a partnership, what is the simplest form of tax reporting and payment they will be allowed to use?
 - a. They can simply divide the partnership's income and expenses into quarters, and each of them can report his or her quarter on a Schedule C attached to their personal income tax returns, and not have the partnership itself report or pay anything.
 - b. The partnership can report all of its income and expenses on a tax return filed in the partnership's name, and pay any tax that may be due, and not have Anne, Beth, Carl and Doug report or pay anything.
 - c. If the partnership loses money, option "b" can be used; but if the partnership makes money, option "a" will have to be used.
 - d. The partnership will have to report all of its income and expenses on a tax return filed in the partnership's name, but the partnership will not pay taxes itself, even if the partnership is profitable. In addition, Anne, Beth, Carl and Doug each will have to report their shares of the partnership's profits or losses on their own personal tax returns; and if the partnership made a profit, each of them will have to pay tax on his or her own share of that profit.
2. How will the partnership calculate whether it made a profit or suffered a loss?
 - a. Using precisely the same rules that Anne, Beth, Carl and Doug would have used, if one of them had run the business as a sole proprietorship (rather than as a partnership) – i.e., all of the rules that were covered in the Survey of Federal Income Tax course.
 - b. Using most of the same rules that Anne, Beth, Carl and Doug would have used, if one of them had run the business as a sole proprietorship (rather than as a partnership) – i.e., most of the rules that were covered in the Survey of Federal Income Tax course.
 - c. Using an entirely separate and different set of rules than the rules that Anne, Beth, Carl and Doug would have used, if one of them had run the business as a sole proprietorship (rather than as a partnership) – i.e., none of the rules that were covered in the Survey of Federal Income Tax course would be used.

3. Which, if any, of the following types of expenses will the partnership be able to deduct, assuming of course the partnership actually incurs such expenses?
- I. personal exemptions for each of the partners
 - II. charitable contributions made by the partnership
 - III. rent
 - IV. utilities
 - V. advertising
 - VI. accounting and legal fees (for operations, not start-up)
 - VII. all of the above
 - VIII. none of the above
- a. I and II.
 - b. III, IV, V and VI.
 - c. VII.
 - d. VIII.

Read (in Schwarz & Lathrope)

Pages 459-462

Internal Revenue Code provisions re Determining Profits at the Partnership Level

§ 701. Partners, not partnership, subject to tax

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

§ 703. Partnership computations

- (a) Income and deductions. The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that -
 - (1) the items described in section 702(a) [reproduced below] shall be separately stated, and
 - (2) the following deductions shall not be allowed to the partnership: [personal exemptions; deduction for taxes paid to foreign countries; deduction for charitable contributions; itemized deductions for individuals; and a couple of others].
- (b) Elections of the partnership. Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership [with certain exceptions].

§ 6221. Tax treatment determined at partnership level

Except as otherwise provided in this subchapter, the tax treatment of any partnership item . . . shall be determined at the partnership level.

§ 6031. Return of partnership income

- (a) General rule. Every partnership . . . shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable. . . .

Look at Tax Form

Form 1065 (a copy of which is at the end of these Study Guides).

Tax Consequences to Partners

Pass Through Items

Questions re Pass Through Items

As you read the assignment and Code sections below, watch for the answers to these questions:

4. During its first year of operation, the partnership did the following:
 - The partnership didn't immediately need all of the \$100,000 contributed by Anne; but instead of depositing the money in a bank account that didn't pay interest, the partnership purchased short-term corporate notes that did pay interest. As the partnership needed cash, it sold the notes, and made a \$10,000 profit doing so!
 - The partnership discovered that some of the equipment that Carl contributed was not suitable for its business, so it sold the unsuitable equipment, and made another \$10,000 profit doing so. Some of that profit was the result of the partnership's recapture of depreciation Carl previously took; but some of that profit was the result of the sale of the equipment for more than Carl originally paid for, when he bought it (more than a year before the partnership sold it).
 - The partnership contributed \$1,000 to a local charity.
 - The partnership lost \$19,000 on its day-to-day operations (i.e., its expenses – not including any of the three items above – exceeded its total income by \$19,000).

How will these matters be reported by Anne, Beth, Carl and Doug?

- a. The partnership tax return will show that it had ordinary business income of \$0 (\$20,000 in profit from the sale of the notes and equipment, less \$1,000 charitable contribution, less \$19,000 lost on operations); and each partner will report \$0 income on his or her personal tax return.
- b. The partnership return will show that it had an ordinary business loss of \$19,000; and each partner will *report* a loss of \$4,750 on his or her personal tax return (though whether it will be *deductible* by all partners remains to be seen). Also, each partner will report and deduct a charitable contribution of \$250 (25% of the \$1,000 contributed by the partnership) on his or her personal income tax return. And each partner will report and include in gross income his or her share of the \$10,000 gain from the sale of the notes, and his or her share of the \$10,000 gain from the sale of the equipment.

5. When Anne, Beth, Carl and Doug report their shares of the partnership's gain from the sale of the equipment, will they report a *short-term* or a *long-term* capital gain on the portion of the gain attributable to the partnership's sale of the equipment for more than Carl originally paid for it?
- It will be a short-term capital gain as to Anne, Beth and Carl, because they were partners in the partnership for less than a year when the partnership sold the equipment. But it will be a long-term capital gain as to Carl, because he owned the equipment for more than a year, first personally, and then through the partnership.
 - It will be a long-term capital gain as to all four of them, because the partnership's holding period in the equipment was the same as Carl's; and the short or long-term character of the equipment as reported by all four is the same as it was in the hands of the partnership.

Read (in Schwarz & Lathrope)

Pages 462-463

Internal Revenue Code provisions re Pass Through Items

§ 702. Income and credits of partner

- General rule. In determining his income tax, each partner shall take into account separately his distributive share of the partnership's -
 - gains and losses from sales or exchanges of capital assets held for not more than 1 year,
 - gains and losses from sales or exchanges of capital assets held for more than 1 year,
 - gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),
 - charitable contributions . . . ,
 - dividends . . .
 - taxes . . . paid . . . to foreign countries . . . ,
 - other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, and
 - taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.
- Character of items constituting distributive share. The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly from the source from which [it was] realized by the partnership, or incurred in the same manner as incurred by the partnership.

Look at Tax Forms (copies of which are at the end of these Study Guides)

Schedule K-1

Form 1040 (especially Line 17)

Schedule E (especially Page 2, Part II)

Basis Adjustments

Questions re Basis Adjustments

As you read the assignment and Code section below, watch for the answers to these questions:

6. What effect, if any, will the partnership's \$19,000 loss have on Anne's \$100,000 basis in the partnership?
 - a. None, because the loss is offset by the partnership's \$20,000 gain on the sale of its notes and equipment, less the \$1,000 charitable contribution it made.
 - b. The loss will reduce Anne's basis in the partnership by \$19,000, from \$100,000 to \$81,000.
 - c. The loss will reduce Anne's basis in the partnership by her 25% of the loss, that is, by \$4,750, from \$100,000 to \$95,250.
7. Recall that Carl's basis in the partnership is \$25,000 (because even though the property he contributed had a fair market value of \$100,000, his basis in that equipment was just \$25,000 by the time he contributed it). What effect, if any, will the partnership's \$19,000 loss have on Carl's \$25,000 basis in the partnership?
 - a. None, because the loss is offset by the partnership's \$20,000 gain on the sale of its notes and equipment, less the \$1,000 charitable contribution it made.
 - b. The loss will reduce Carl's basis in the partnership by \$19,000, from \$25,000 to \$6,000.
 - c. The loss will reduce Carl's basis in the partnership by his 25% of the loss, that is, by \$4,750, from \$25,000 to \$20,250.
8. Suppose the partnership eventually loses \$200,000. (For example, suppose it runs through all of the cash contributed by Anne, and it then sells the property contributed by Beth and more of the equipment contributed by Carl, and it loses that too. Or, suppose the partnership borrowed money from a bank, and lost that money too.) What effect would this have on Carl's basis in the partnership?
 - a. It would reduce Carl's basis to -\$25,000, because his share of a \$200,000 loss would be \$50,000 and his original basis was \$25,000.
 - b. It would reduce Carl's basis to \$0, because even though his share of a \$200,000 loss would be \$50,000, his original basis of \$25,000 would not be reduced below zero.
 - c. It depends on whether the \$200,000 loss all took place in a single year, or was spread out over more than a year.

Read (in Schwarz & Lathrope)

Pages 463-464

Internal Revenue Code provision re Basis Adjustments

§ 705. Determination of basis of partner's interest

- (a) General rule. The adjusted basis of a partner's interest in a partnership shall . . . be the basis of such interest determined under section 722 (relating to contributions to a partnership) . . . -
- (1) increased by the sum of his distributive share for the taxable year and prior taxable years of -
 - (A) taxable income of the partnership as determined under section 703(a) . . .
 - (2) decreased (but not below zero) . . . by the sum of his distributive share for the taxable year and prior taxable years of -
 - (A) losses of the partnership. . . .

Limitation on Losses

The previous part of this lesson dealt with the impact of losses on each partner's *basis*. Eventually, of course, that impact will affect the partners' *taxes*, when they sell their partnership interests and report a gain or loss on that sale. Losses also – and separately – may have an immediate impact on the partners' taxes. I say "may" have, because even though, as a general rule, a partner's share of partnership losses is deductible by the partner against his or her income from other sources, there are important limits to that general principle. Those limits are what this part of the lesson is about.

Questions re Limitations on Losses

As you read the assignment and Code sections below, watch for the answers to these questions:

9. Recall that Doug's basis in the partnership is \$100,000 (because that is the amount he had to recognize as income, when he received his interest in exchange for his services). Recall too that Doug will be working in the business. How much will Doug be able to deduct (from his other income) if the partnership loses \$19,000 in its first year of operations?
 - a. Nothing.
 - b. \$4,750 (25% of the \$19,000 loss).
10. Recall that Anne's basis in the partnership is \$100,000 (because that is the amount of cash she invested, in return for her partnership interest). Recall too that Anne isn't working in the partnership. Only Doug is working. How much will Anne be able to deduct (from her other income) if the partnership loses \$19,000 in its first year of operations?
 - a. Nothing.
 - b. \$4,750 (25% of the \$19,000 loss).
11. If your answer to Question 10 was "a", why?
 - a. Anne was not "at risk."
 - b. Anne's share of the loss was a "passive activity loss."

12. If your answers to Questions 9 and 10 were "a", may Doug and Anne deduct their losses against their shares of gains from the sale of the notes and equipment?
- a. Yes.
 - b. No.

Read (in Schwarz & Lathrope)

Pages 464-471

Internal Revenue Code provisions re Limitations on Losses

§ 704(d) Limitation on allowance of losses.

A partner's distributive share of partnership loss . . . shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

§ 465. Deductions limited to amount at risk

- (a) Limitation to amount at risk
 - (1) In general. In the case of -
 - (A) an individual . . . engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk . . . for such activity at the close of the taxable year.
 - . . .
 - (b) Amounts considered at risk
 - (1) In general. For purposes of this section, a taxpayer shall be considered at risk for an activity with respect to amounts including -
 - (A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and
 - (B) amounts borrowed with respect to such activity [under specified circumstances].
 - . . .
 - (d) Definition of loss
 - For purposes of this section, the term "loss" means the excess of the deductions allowable under this chapter for the taxable year (determined without regard to the first sentence of subsection (a)) and allocable to an activity to which this section applies over the income received or accrued by the taxpayer during the taxable year from such activity. . . .

§ 469. Passive activity losses and credits limited

(a) Disallowance

(1) In general. If for any taxable year the taxpayer is described in paragraph (2), neither -

- (A) the passive activity loss, nor
 - (B) the passive activity credit,
- for the taxable year shall be allowed.

(2) Persons described. The following are described in this paragraph:

- (A) any individual. . . .

. . .

(c) Passive activity defined. For purposes of this section -

(1) In general. The term "passive activity" means any activity -

- (A) which involves the conduct of any trade or business, and
- (B) in which the taxpayer does not materially participate.

. . .

(h) Material participation defined. For purposes of this section -

(1) In general. A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is -

- (A) regular,
- (B) continuous, and
- (C) substantial.

(2) Interests in limited partnerships. Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.

Study Guide 7

OPERATING A BUSINESS

Operating a Partnership

Allocating Partners' "Distributive Shares" (Part 1)

Allocating Partners' "Distributive Shares"

Recall (from Study Guide 6) that partners report their individual shares of a partnership's profits or losses, *but* some items are disregarded in calculating the *partnership's* profits or losses, and instead, those items are distributed directly to the partners, and the partners report their shares of those specific items themselves on their own tax returns. The items that are distributed directly to partners (and thus are not taken into account in calculating the partnership's profits or losses) are: short and long-term capital gains or losses; gains or losses from the sale of business equipment; charitable contributions made by the partnership; dividends received by the partnership; and taxes paid by the partnership to foreign countries. Here again is the language of the Internal Revenue Code that requires this to be done:

§ 702. Income and credits of partner

- (a) General rule. In determining his income tax, each partner shall take into account separately his distributive share of the partnership's -
- (1) gains and losses from sales or exchanges of capital assets held for not more than 1 year,
 - (2) gains and losses from sales or exchanges of capital assets held for more than 1 year,
 - (3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),
 - (4) charitable contributions . . . ,
 - (5) dividends . . .
 - (6) taxes . . . paid . . . to foreign countries . . . ,
 - (7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, and
 - (8) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

Recall too that you saw how this is handled as a mechanical matter when you looked at the Form 1065 Partnership Return, Schedule K-1, Form 1040 Individual Income Tax Return, and Schedule E.

The issue addressed in this Study Guide is how each partner's share - i.e., his or her percentage - of the partnership's profits or losses and of the other separately-distributed items is determined.

So far this semester, we have simply assumed that since Anne, Beth, Carl and Doug each will own 25% of the partnership, each of them will report 25% of the partnership's profits or losses and 25% of each of the other items too. If Anne, Beth, Carl and Doug actually do wish to do that, then the issues covered by this Study Guide 7 will not matter. They won't,

because a 25% allocation to each 25% partner is what the Internal Revenue Code would require if that's what the partnership agreement said. Here is the Internal Revenue Code provision that makes this so:

§ 704. Partner's distributive share

- (a) Effect of partnership agreement. A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

What's more, the Internal Revenue Code makes an equal allocation among equal partners (or a 60/40 allocation among 60/40 partners, etc.) the rule by default, if the partnership agreement doesn't say anything at all about allocations. (Partnership agreements often are silent about allocations, especially if the partnership is a general partnership and the agreement is oral.) Here is the section of the Code that so provides:

§ 704. Partner's distributive share

- ...
(b) Determination of distributive share. A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if -
(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof). . . .

Notice, though, that § 704(a) *seems* to say that *if* the partnership agreement among Anne, Beth, Carl and Doug provided for something *other than* a 25% allocation of profits or losses and other items, that would be OK too, even though each of them has a 25% interest in the partnership. The reason that I say "seems to say" is that section 704(a) also includes the (ever-popular) phrase "except as otherwise provided." And that is what this Study Guide 7 is about: partnership agreements that allocate profits or losses – and especially those that allocate the other items – out of proportion to the partners' interests in the partnership.

Right about now, you may be wondering why any partners would ever want to make allocations that are different from their ownership interests. Think back to your study (in the Survey course) of the assignment-of-income doctrine, and recall why taxpayers have attempted to assign their incomes to others: those others were in lower tax brackets than the taxpayers who assigned their income, and the assignment was done (in a usually unsuccessful effort) to save taxes. Partnerships are perfect vehicles for assigning income too. Partnerships also are perfect vehicles for assigning other tax-significant items away from partners who can't take advantage of them to partners who can.

Recall, for example, that capital losses may be deducted without limit against a taxpayer's capital gains, *if* the taxpayer has capital gains, but only against \$3,000 a year of ordinary income. Recall too that charitable contributions are deductible, but only by taxpayers who itemize their deductions, and subject to limits geared to the taxpayer's adjusted gross income. One more example: individual taxpayers may take deductions only against their income for the year in which the deductible expenses were incurred; individuals are not permitted to carry deductions forward into future years (as a general rule).

So, since agreements among partners may be used (as a matter of state law) to shuffle items of partnership income and expense back and forth among the partners – *to* those partners who can best take advantage of them and *away* from those partners who can't – that's exactly what partnerships would be used to do, *especially* if partners were permitted to make these agreements at the end of the tax year, when the partners know exactly what's available to be shuffled around. You're probably thinking that even if partners are permitted to agree on disproportionate allocations, they can't wait until year-end to do it. But take a look at the following section of the Code. (You'll see that partners are permitted to wait until after the end of the tax-year to make allocations!)

§ 761. Terms defined

- (c) Partnership agreement. For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

This brings us back to the "except as otherwise provided" phrase in § 704(a) – the phrase that alerts us to the fact that there are limits to the extent to which partners may make allocations that are not in proportion to their interests in the partnership. Here is the specific language of the Code that imposes such a limit:

§ 704. Partner's distributive share

- (b) Determination of distributive share. A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if –
 - (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Notice that § 704(b)(2) contains a double-negative. That is, it provides that the partners' shares of income and other items will be allocated in proportion to their ownership interests, and *not* as they have agreed, if the allocation they agreed to does *not* have substantial economic effect. Restating this, to eliminate the double-negative, § 704(b)(2) says that the partners' shares will be allocated in the way in which they agreed, if their agreement does have a substantial economic effect.

So, drawing together all the Code sections quoted above, we have this:

- Allocations (of profits or losses, and the other separately stated items) for tax purposes will be made to partners in proportion to their ownership interests in the partnership, unless the partners have agreed to a different allocation.
- Partners are permitted to agree to allocations that are not in proportion to their ownership interests. They even may make such agreements after the close of the partnership's tax year (so long as they do so before the partnership tax return is due). However, if partners do make such an agreement, the allocations they have agreed to will be valid for tax purposes, only if the agreement has a "substantial economic effect."
- If the agreement does *not* have a
 - substantial
 - economic effectthen for tax purposes, the partners' agreement will be ignored, and allocations will be made in proportion to the partners' interests in the partnership.

The reading assignments and questions in this Study Guide are intended to explain and illustrate what constitutes an "economic effect," and how big an economic effect must be in order to be "substantial."

The "economic effect" that must exist (in order for agreed-upon, non-proportional allocations to be valid for tax purposes) is *not* an effect on the taxpayers' *taxes*. Effects on *taxes* (but nothing else) are what the law seeks to prevent.

Instead, the "economic effect" that must exist (for allocation agreements to be valid) is an effect on the relative value of the partners' interests in the partnership. The relative values of the partners' interests is measured by their "capital accounts" which is an *accounting* concept (not a market concept or anything that can be touched or held). Hence, the first reading assignment explains the "capital account" concept, and the questions that follow are intended to illustrate how that concept is applied.

Capital Accounts

Read (in Schwarz & Lathrope)

Pages 472-475 (first three lines only)

Questions re Capital Accounts

For the following questions, assume that although Doug will be the primary worker, Anne, Beth and Carl will be sufficiently involved in the partnership's activities so that if the partnership suffers a loss, that loss will not be a passive activity loss as to them.

1. In return for their interests in the partnership, Anne contributes \$100,000 cash, Beth contributes real estate worth \$100,000 in which she has a basis of \$50,000, Carl contributes equipment worth \$100,000 in which he has a basis of \$25,000, and Doug contributes his services worth \$100,000. Which of the following is the partnership's balance sheet (once the partnership is formed, but before it incurs any expenses or earns any income)?

a. ASSETS		LIABILITIES/PARTNERS' CAPITAL	
Cash	\$100,000	Liabilities	\$ 0
Real Estate	\$ 50,000	Capital	
Equipment	\$ 25,000	Anne	\$100,000
Services to be rendered	<u>\$100,000</u>	Beth	\$ 50,000
Total	\$275,000	Carl	\$ 25,000
		Doug	<u>\$100,000</u>
		Total	\$275,000

b. ASSETS		LIABILITIES/PARTNERS' CAPITAL	
Cash	\$100,000	Liabilities	\$ 0
Real Estate	\$100,000	Capital	
Equipment	\$100,000	Anne	\$100,000
Services to be rendered	<u>\$100,000</u>	Beth	\$100,000
Total	\$400,000	Carl	\$100,000
		Doug	<u>\$100,000</u>
		Total	\$400,000

2. Same facts as Question 1, with this change: If the partnership uses \$10,000 worth of Doug's services during its first month of existence (but doesn't do anything else to spend money or earn income), which of the following is the partnership's balance sheet at the end of that month?

a. ASSETS		LIABILITIES/PARTNERS' CAPITAL	
Cash	\$100,000	Liabilities	\$ 0
Real Estate	\$ 50,000	Capital	
Equipment	\$ 25,000	Anne	\$100,000
Services to be rendered	<u>\$ 90,000</u>	Beth	\$ 50,000
Total	\$265,000	Carl	\$ 25,000
		Doug	<u>\$ 90,000</u>
		Total	\$265,000

b. ASSETS		LIABILITIES/PARTNERS' CAPITAL	
Cash	\$100,000	Liabilities	\$ 0
Real Estate	\$100,000	Capital	
Equipment	\$100,000	Anne	\$ 97,500
Services to be rendered	<u>\$ 90,000</u>	Beth	\$ 97,500
Total	\$390,000	Carl	\$ 97,500
		Doug	<u>\$ 97,500</u>
		Total	\$390,000

3. What points are being made by Questions 1 and 2?
- On a partnership's balance sheet, assets are listed at their fair market value, not at the partnership's basis.
 - On a partnership's balance sheet, each partner's capital account is listed at his or her share of the partnership's assets, measured by the fair market value, not at the partnership's basis.
 - In the absence of an agreement otherwise, a partner's capital account is increased or decreased by the amount equal to his or her interest in the partnership, without regard to where the increase or decrease came from (e.g., without regard to whether a decrease was the result of spending cash contributed by just one of the partners, or of using services provided by just one of the partners).
 - All of the above.
4. What does the amount in a partner's capital account represent?
- That partner's basis in whatever he or she contributed to the partnership.
 - The partner's (outside) basis in the partnership itself.
 - The partner's share (stated in dollars) of the partnership's (inside) basis in the assets that were contributed to it.
 - The partner's share (stated in dollars) of the value of partnership's assets.

Economic Effects

Understanding what partnership capital accounts are and how they work is important, because in order to decide whether an allocation agreement has an "economic effect," it is necessary to determine what effect the agreed-upon allocation has on the partners' capital accounts, and what the consequences to the partners will be as a result of changes in their capital accounts if and when the partnership is liquidated. There are three alternative tests for determining whether an allocation has an "economic effect." (They are alternatives, because an agreement that satisfies any one of the tests will have an "economic effect.") The first and most basic of these tests is referred to in the reading assignment as "The Big Three," because to satisfy that test, an allocation agreement among partners must contain three elements.

Read (in Schwarz & Lathrope)

Pages 475-478 re "The Big Three Test"

When you read these pages, pay close attention to the examples they contain. Sketch out balance sheets of your own for the examples, if doing so is necessary for you to understand them. The questions that follow are not simply alternative versions of the same facts, using different names.

Questions re "The Big Three" Test

5. This is the balance sheet of the partnership formed by Anne, Beth, Carl and Doug, immediately after they formed it, and before they began doing any business at all.

ASSETS		LIABILITIES/PARTNERS' CAPITAL	
Cash	\$100,000	Liabilities	\$ 0
Real Estate	\$100,000	Capital	
Equipment	\$100,000	Anne	\$100,000
Services to be rendered	<u>\$100,000</u>	Beth	\$100,000
Total	\$400,000	Carl	\$100,000
		Doug	<u>\$100,000</u>
		Total	\$400,000

During the first year of the partnership's operation, it used up \$50,000 of the cash contributed by Anne, took \$5,000 of depreciation on the real estate contributed by Beth, took \$5,000 of depreciation on the equipment contributed by Carl, and used \$50,000 of Doug's services. (The partnership made sales and paid expenses. But the partnership's expenses exceeded its sales by \$50,000, and that is why it used \$50,000 in cash.) As a result, by the end of that year, the partnership lost \$110,000, had the following assets on hand; and if the partnership's loss were allocated to the partners in proportion to the equal 25% interests in the partnership, each partner would have \$72,500 in his or her capital account:

ASSETS		LIABILITIES/PARTNERS' CAPITAL	
Cash	\$ 50,000	Liabilities	\$ 0
Real Estate	\$ 95,000	Capital	
Equipment	\$ 95,000	Anne	\$ 72,500
Services to be rendered	<u>\$ 50,000</u>	Beth	\$ 72,500
Total	\$290,000	Carl	\$ 72,500
		Doug	<u>\$ 72,500</u>
		Total	\$290,000

Suppose, though, that at the end of the year (but before the partnership tax return was due to be filed), the partners agreed to allocate the \$110,000 loss among them as follows: \$50,000 to Anne; \$5,000 to Beth; \$5,000 to Carl; and \$50,000 to Doug.

Suppose that they also agreed: (1) to maintain their capital accounts so that their capital accounts reflected these allocations; (2) that if the partnership were liquidated, remaining assets would be allocated in accordance with those capital accounts, unless someone's capital account had a deficit; and (3) if someone's capital account had a deficit, that partner would have to make a further contribution to the partnership to bring his or her capital account up to \$0. If this agreement were made, the partnership balance sheet at the end of the year would look like this:

ASSETS		LIABILITIES/PARTNERS' CAPITAL	
Cash	\$ 50,000	Liabilities	\$ 0
Real Estate	\$ 95,000	Capital	
Equipment	\$ 95,000	Anne	\$ 50,000
Services to be rendered	<u>\$ 50,000</u>	Beth	\$ 95,000
Total	\$290,000	Carl	\$ 95,000
		Doug	<u>\$ 50,000</u>
		Total	\$290,000

Which of the following is correct?

- a. This allocation satisfies the "economic effects" requirement, so that each of the partners would be permitted to recognize the portion of the loss allocated to him or her.
 - b. This allocation does not satisfy the "economic effects" requirement, and therefore the IRS would reallocate the partnership's \$110,000 loss so that each of them would have to recognize a loss of \$27,500.
6. Same facts as Question 5, with this exception: the partners agreed that the entire \$110,000 loss would be allocated to Anne (none of it among the others), and if the partnership were liquidated, each of them would get back whatever remained of whatever they contributed when the partnership was first formed, regardless of the amount of their capital accounts. To see how this would work, here is the balance sheet that would be the result of this allocation:

ASSETS		LIABILITIES/PARTNERS' CAPITAL	
Cash	\$ 50,000	Liabilities	\$ 0
Real Estate	\$ 95,000	Capital	
Equipment	\$ 95,000	Anne	(\$ 10,000)
Services to be rendered	<u>\$ 50,000</u>	Beth	\$100,000
Total	<u>\$290,000</u>	Carl	\$100,000
		Doug	<u>\$100,000</u>
		Total	<u>\$290,000</u>

If the partnership were liquidated at the end of that first year, Anne would get \$50,000; Beth would get back her real estate; Carl would get back his equipment; and Doug would get back his remaining obligation to provide services.

Which of the following is correct?

- a. This allocation satisfies the "economic effects" requirement, so that each of the partners would be permitted to recognize the portion of the loss allocated to him or her.
 - b. This allocation does not satisfy the "economic effects" requirement, and therefore the IRS would reallocate the partnership's \$110,000 loss so that each of them would have to recognize a loss of \$27,500.
7. Same facts as Question 6, with this exception: the partners agreed that if the partnership were liquidated, they would distribute any remaining assets among them equally, regardless of the amount in their capital accounts.

Which of the following is correct?

- a. This allocation satisfies the "economic effects" requirement, so that each of the partners would be permitted to recognize the portion of the loss allocated to him or her.
- b. This allocation does not satisfy the "economic effects" requirement, and therefore the IRS would reallocate the partnership's \$110,000 loss so that each of them would have to recognize a loss of \$27,500.

Read (in Schwarz & Lathrope)

Pages 478-481 re the "Alternate Test"

Questions re the "Alternate Test"

8. Same facts as Question 5, with this exception: the partners agreed that the first \$100,000 of loss will be allocated to Anne (none of it among the others); that any further losses will be evenly distributed between Beth and Carl until their capital accounts are \$0; that any further losses will be distributed to Doug until his capital account is \$0; and then (when the capital accounts of all four are \$0), any further losses will be distributed among the four of them equally. They also agreed that if the partnership were liquidated, any remaining assets would be allocated in accordance with their partners' capital accounts.

If the partnership were liquidated at the end of that first year, Anne wouldn't get anything because her capital account would be \$0; Beth, Carl and Doug would divide the remaining assets equally.

Which of the following is correct?

- a. This allocation satisfies the "economic effects" requirement, so that each of the partners would be permitted to recognize the portion of the loss allocated to him or her.
- b. This allocation does not satisfy the "economic effects" requirement, and therefore the IRS would reallocate the partnership's \$110,000 loss so that each of them would have to recognize a loss of \$27,500.

Read (in Schwarz & Lathrope)

Pages 481-482 (top four lines) re "Economic Effect Equivalence"

9. Many – perhaps most – partnership agreements are oral, and thus do not contain provisions concerning the maintenance of capital accounts, the manner in which distributions will be made if the partnership is liquidated, or a requirement that deficits in capital accounts be restored. Yet, many partnerships make year-end allocations, by agreement among their partners, in which some partners are allocated more profits than others, or more losses than others. Even in the absence of a formal, written agreement, something has to be done with each partner's capital account at the end of the year, because changes in each partner's capital account must be reported on Schedule K-1 (see Lines J and L). If:

- the partner's capital accounts are increased or decreased to accurately reflect agreed-upon allocations, and
- state law gives partners a right of contribution against one another, for the payment of partnership debts by a partner,

which of the following is correct?

- a. The agreed-upon allocation will satisfy the "economic effects" requirement, so that each of the partners will be permitted to recognize the gain, loss or other tax item allocated to him or her.
- b. The agreed-upon allocation will not satisfy the "economic effects" requirement, and therefore the IRS would reallocate the partnership's profits, losses and other items so that each of partner will have to recognize a share equal to his or her interest in the partnership.

Substantiality

In order for an agreed-upon allocation to be valid for tax purposes, it has to have an economic effect on the capital accounts of the partners, and on their rights and obligations in the event the partnership is liquidated, and the effect must be "substantial." The Code requires that the effect be "substantial," because it is easy for partners to agree to an allocation that satisfies "The Big Three" test – and thus automatically satisfy the "economic effects" requirement – without some types of allocations actually affecting the partners' relative interests in the partnership as measured by the amounts in their capital accounts.

"The Big Three" test simply requires that

- the partnership maintain capital accounts so that the partners' capital accounts reflect agreed-upon allocations;
- if the partnership is liquidated, remaining assets be distributed in accordance with those capital accounts, unless someone's capital account has a deficit; and
- if someone's capital account has a deficit, that partner has to make a further contribution to the partnership to bring his or capital account up to \$0.

Suppose that a partnership agreement contains all three of these elements. Then suppose that the items to be allocated are capital gains and ordinary income. If \$1,000 in capital gains are allocated to a high tax bracket partner who has a half interest in partnership, and \$1,000 of ordinary income is allocated to a low tax bracket partner who has a half interest in the partnership, both of their capital accounts will be increased by an identical \$1,000, so the allocation has no actual effect on their relative interests in the partnership. But the allocation may well have an effect on their taxes, by lowering the high bracket partner's tax substantially without increasing the low bracket partner's tax substantially. In other words, this allocation would not have any effect, except on taxes. Thus, the allocation would not have a "substantial" economic effect, and would result in the IRS reallocating the capital gains and ordinary income between the partners equally.

Read (in Schwarz & Lathrope)

Pages 483-484 re Substantiality

Pages 484-488 (will not be covered in class or on the test)

Question re Substantiality

10. Does the allocation described in Question 5 satisfy the requirement that the allocation have a *substantial* economic effect?
- a. Yes.
 - b. No.

Partner's Interest

Earlier in this Study Guide, I wrote that if the agreement does not have a substantial economic effect, then for tax purposes, the partners' agreement will be ignored, and allocations will be made in proportion to the "partners' interests in the partnership." How, though, is a partner's interest calculated, especially if the partners contributed different amounts (or assets having different values) to the partnership's capital, they have different interests in the partnership's profits and losses, and different interests in the partnership's assets if the partnership is liquidated? That is the subject of the next reading assignment.

Read (in Schwarz & Lathrope)

Pages 488-490 re Partner's Interest

Question re Partner's Interest

11. So far, we have been saying that Anne, Beth, Carl and Doug each have a 25% interest in their partnership, simply because the contributions of each were worth the same amount. Suppose though that Anne, Beth, Carl and Doug enter into an allocation agreement that does *not* have a substantial economic effect, resulting in a reallocation by the IRS in accordance with their interests in the partnership. What will the IRS look at to determine what their interests are?
- a. Their contributions to the partnership.
 - b. Their agreement with respect to the distribution among them of any remaining partnership assets, if the partnership is liquidated.
 - c. Their agreement with respect to the division among them of the partnerships' profits and cash flow.
 - d. All of the above.

Study Guide 8

OPERATING A BUSINESS

Operating a Partnership

Allocating Partners' "Distributive Shares" (Part 2)

Allocating Partners' "Distributive Shares"

Study Guide 7 covered provisions of the Code that are designed to prevent partners from allocating income and other items among themselves, in a manner that differs from their ownership interests in the partnership, for the purpose of reducing their taxes. The Code does this using a set of rules that are quite intricate. In a nutshell, however, you saw that the partners' agreed-upon allocations will be valid for tax purposes, *if* the partners also have agreed that:

1. their allocations will be reflected by increases or decreases in the amounts in their capital accounts, and that upon liquidation of the partnership, the amounts in their capital accounts will determine
 2. the value of the assets they will receive, or
 3. the amount of money they will have to contribute to the payment of partnership debts.
- You will recognize these three points as "The Big Three" requirements for valid allocations of partnership income, losses and other items.

This Study Guide covers provisions of the Code that are designed to prevent partners from actively *using* "The Big Three" requirements to reduce their taxes – something they would be able to do, were it not for the Code provisions we will study now, if the partnership's assets include contributed property.

Allocation of Gain or Loss on Sales or Exchanges of Contributed Property

Contributed property enables partners to manipulate the allocation of gains, losses, and depreciation deductions, because there usually is a difference between the property's fair market value and its basis. As you will recall from Study Guide 7 (Questions 1-4), each partner's capital account reflects his or her share of the fair market value the partnership's property, not its basis. Thus, *if* a partnership's gain from the sale of property (i.e., the amount it realized less its *basis* in the property) could be allocated among the partners in proportion to their interests in the partnership, the partner who originally contributed the property could shift a portion of what otherwise would have been his or her gain to the other partners. In the abstract, this may not be very obvious. But the following reading assignment, and especially its examples, should clear things up for you.

One last point: The reading assignment introduces two new columns into the partnership balance sheet. In the example on page 492, the columns are headed "A.B." which stands for "Adjusted Basis." In other words, the partnership balance sheet now reflects both the adjusted basis of contributed property and its fair market value (which the balance sheet lists in a column headed "Bk. Value," i.e., Book Value).

Read (in Schwarz & Lathrope)

Pages 491-495 (to be discussed in class)

Pages 495-497 (for your information; not be discussed in class or tested upon)

Internal Revenue Code and Regulation provisions re Allocations from Sales or Exchanges of Contributed Property

§ 704. Partner's distributive share

. . .

(c) Contributed property

(1) In general. Under regulations prescribed by the Secretary -

(A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. . . .

Reg. § 1.704-3 Contributed property

(a) In general—

(1) General principles. The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. . . . [T]he allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). . . . [I]t is not reasonable to use an allocation method . . . under which the partnership creates tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts. . . .

Questions re Allocations from Sales or Exchanges of Contributed Property

1. In return for their interests in the partnership, Anne contributes \$100,000 cash, Beth contributes real estate worth \$100,000 in which she has a basis of \$50,000, Carl contributes equipment worth \$100,000 in which he has a basis of \$25,000, and Doug contributes his services worth \$100,000. Which of the following is the partnership's balance sheet (once the partnership is formed, but before it incurs any expenses or earns any income)?

<u>ASSETS</u>			<u>LIABILITIES/PARTNERS' CAPITAL</u>	
	<u>Adj Basis</u>	<u>Book Value</u>	<u>Adj. Basis</u>	<u>Book Value</u>
Cash	\$100,000	\$100,000	Liabilities	\$0
Real Estate	\$ 50,000	\$100,000	Capital	
Equipment	\$ 25,000	\$100,000	Anne	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Beth	\$ 50,000
Total	\$275,000	\$400,000	Carl	\$ 25,000
			Doug	<u>\$100,000</u>
			Totals	\$275,000
				\$400,000

<u>ASSETS</u>			<u>LIABILITIES/PARTNERS' CAPITAL</u>	
	<u>Adj Basis</u>	<u>Book Value</u>	<u>Adj. Basis</u>	<u>Book Value</u>
Cash	\$100,000	\$100,000	Liabilities	\$0
Real Estate	\$100,000	\$ 50,000	Capital	
Equipment	\$100,000	\$ 25,000	Anne	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Beth	\$ 50,000
Total	\$275,000	\$400,000	Carl	\$ 25,000
			Doug	<u>\$100,000</u>
			Totals	\$275,000
				\$400,000

2. Shortly after the partnership was formed, it determined that the real estate Beth had contributed wasn't really suitable for the partnership's business, after all. So the partnership sold the property for \$100,000. For tax purposes, how much of a gain did the partnership realize, and to whom will that gain be allocated, if Anne, Beth, Carl and Doug agreed to share partnership income or losses equally, and also agreed to comply with The Big Three requirements?
- The partnership did not realize any gain, because it sold the real estate for its book value; and thus the partnership doesn't have any gain to allocate to any of the partners.
 - The partnership realized a gain of \$50,000, because it sold the real estate for \$50,000 more than the partnership's basis; and it will allocate \$12,500 of that gain to each of the four partners, because they agreed to share partnership income equally.
 - The partnership realized a gain of \$50,000, because it sold the real estate for \$50,000 more than the partnership's basis; and it will allocate all \$50,000 of that gain to Beth, because when she contributed the real estate to the partnership, she had \$50,000 "built-in gain" in the property, all of which must be allocated to her under § 704(c).

3. Suppose that instead of selling the real estate for \$100,000 (as in Question 2), the partnership sold the property for \$120,000. For tax purposes, how much of a gain did the partnership realize, and to whom will that gain be allocated, if Anne, Beth, Carl and Doug agreed to share partnership income or losses equally, and also agreed to comply with The Big Three requirements?
- a. The partnership realized a \$20,000 gain, because it sold the real estate for \$20,000 more than its book value; and it will allocate \$5,000 of that gain to each of the four partners, because they agreed to share partnership income equally.
 - b. The partnership realized a gain of \$70,000, because it sold the real estate for \$70,000 more than the partnership's basis; and it will allocate \$17,500 of that gain to each of the four partners, because they agreed to share partnership income equally.
 - c. The partnership realized a gain of \$70,000, because it sold the real estate for \$70,000 more than the partnership's basis; and it will allocate all \$70,000 of that gain to Beth, because when she contributed the real estate to the partnership, she had a "built-in gain" in the property, so all of the partnership's gain must be allocated to her under § 704(c).
 - d. The partnership realized a gain of \$70,000, because it sold the real estate for \$70,000 more than the partnership's basis. It will allocate \$50,000 of that gain to Beth, because when she contributed the real estate to the partnership, she had a \$50,000 "built-in gain" in the property, so that much of the partnership's gain must be allocated to her under § 704(c). And the remaining \$20,000 of gain will be allocated, \$5,000 each, to Anne, Carl, Doug and Beth, so Beth will wind up with \$55,000 of the gain and the others will wind up with \$5,000 of the gain each.

4. Suppose that when the partnership was formed, the real estate contributed by Beth had a fair market value of \$100,000, but her basis in the property – and thus the partnership’s basis – was \$110,000 (rather than the \$50,000 we have used as her basis in earlier questions). The partnership sold the real estate for \$90,000. For tax purposes, how much of a loss did the partnership realize, and to whom will that loss be allocated, if Anne, Beth, Carl and Doug agreed to share partnership income or losses equally, and also agreed to comply with The Big Three requirements?
- a. The partnership realized a \$10,000 loss, because it sold the real estate for \$10,000 less than its book value; and it will allocate \$2,500 of that loss to each of the four partners, because they agreed to share partnership losses equally.
 - b. The partnership realized a loss of \$20,000, because it sold the real estate for \$20,000 less than the partnership’s basis; and it will allocate \$5,000 of that loss to each of the four partners, because they agreed to share partnership losses equally.
 - c. The partnership realized a loss of \$20,000, because it sold the real estate for \$20,000 less than the partnership’s basis; and it will allocate all \$20,000 of that loss to Beth, because when she contributed the real estate to the partnership, she had a “built-in loss” in the property, so all of the partnership’s loss must be allocated to her under § 704(c).
 - d. The partnership realized a loss of \$20,000, because it sold the real estate for \$20,000 less than the partnership’s basis. It will allocate \$10,000 of that loss to Beth, because when she contributed the real estate to the partnership, she had a \$10,000 “built-in” loss in the property, so that much of the partnership’s loss must be allocated to her under § 704(c). And the remaining \$10,000 of loss will be allocated, \$2,500 each, to Anne, Carl, Doug and Beth, so Beth will wind up with \$12,500 of the loss and the others will wind up with \$2,500 of the loss each.

Allocation of Depreciation of Contributed Property

As you saw in the balance sheet in Question 1 and in the balance sheet on page 492 of Schwarz & Lathrope, there is a difference between Basis and Book Value. For *tax* purposes, depreciation deductions are calculated using a property's *basis*, not its book value. You will recall this principle from the Survey course, but here again are the Code sections that spell this out (emphasis added on the word "basis"):

§ 167. Depreciation

(a) General rule. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) -

- (1) of property used in the trade or business, or
- (2) of property held for the production of income.

. . .

(c) *Basis* for depreciation

- (1) In general. The *basis* on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011, for the purpose of determining the gain on the sale or other disposition of such property.

§ 1011. Adjusted basis for determining gain or loss

(a) General rule.—The adjusted *basis* for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the *basis* (determined under section 1012 . . .). . . .

§ 1012. Basis of property—cost

The *basis* of property shall be the cost of such property. . . .

Although *basis* is used to calculate depreciation *deductions*, partners' capital accounts use fair market value (also known as "book value") for all other purposes, including compliance with The Big Three. Therefore, a separate depreciation calculation is made in order to adjust capital accounts – a calculation based on fair market value.

Read (in Schwarz & Lathrope)

Pages 497-499 (top three lines)

Pages 499-501 (not to be discussed in class, or covered on the exam)

Here again is the Code section that requires allocations to take into account variations between the basis and fair market value of property contributed to the partnership:

§ 704. Partner's distributive share

. . .

(c) Contributed property

- (1) In general. Under regulations prescribed by the Secretary -
 - (A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. . . .

Questions re Allocation of Depreciation of Contributed Property

Here again is the balance sheet showing the basis and fair market value (aka book value) of the business formed by Anne, Beth, Carl and Doug:

<u>ASSETS</u>			<u>LIABILITIES/PARTNERS' CAPITAL</u>		
	<u>Adj Basis</u>	<u>Book Value</u>	<u>Adj. Basis</u>		<u>Book Value</u>
Cash	\$100,000	\$100,000	Liabilities	\$0	\$0
Real Estate	\$ 50,000	\$100,000	Capital		
Equipment	\$ 25,000	\$100,000	Anne	\$100,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Beth	\$ 50,000	\$100,000
Total	\$275,000	\$400,000	Carl	\$ 25,000	\$100,000
			Doug	<u>\$100,000</u>	<u>\$100,000</u>
			Totals	\$275,000	\$400,000

5. The equipment contributed by Carl had a fair market value of \$100,000, and a basis (in his hands when he contributed it to the partnership, and therefore to the partnership now) of \$25,000. Assume that the partnership is taking depreciation deductions on the equipment at the rate of 10% per year. This means that for *tax* purposes, the depreciation deduction is \$2,500 per year; but the *book value* of the equipment is reduced \$10,000 per year, for the purpose of calculating the partners' capital accounts. How should the \$2,500 per year tax deduction be allocated among the partners?
 - a. All of it should be allocated to Carl, because he contributed the equipment.
 - b. It should be allocated to Anne, Beth, Carl and Doug, in shares of \$625 each, because they agreed to share partnership income and losses equally.
 - c. It should be allocated to Anne, Beth and Doug, in shares of \$833 each, because their shares of the book value depreciation are \$2,500 each (i.e., 25% of \$10,000), and they are entitled to tax depreciation up to that \$2,500 (and \$833 is less).

6. Suppose that the difference between the fair market value of the equipment contributed by Carl and its basis were not as great as it has been in the questions considered so far. Suppose, for example, that Carl's basis, and now the partnership's, is \$80,000, and the fair market value is \$100,000. In this case, depreciation (at 10% per year) will be \$8000 for tax purposes and \$10,000 for book value purposes. How should the \$8000 per year tax deduction be allocated among the partners?
 - a. All of it should be allocated to Carl, because he contributed the equipment.
 - b. It should be allocated to Anne, Beth, Carl and Doug, in shares of \$2000 each, because they agreed to share partnership income and losses equally.
 - c. It should be allocated to Anne, Beth and Doug, in shares of \$2670 each, because Carl already benefitted from not having to recognize the \$20,000 built-in gain he realized when he contributed the equipment to the partnership.
 - d. It should be allocated to Anne, Beth and Doug, in shares of \$2500 each, because their shares of the book value depreciation are \$2500 each (i.e., 25% of \$10,000), and they are entitled to tax depreciation up to that \$2500. And the remaining \$500 (of the \$8000 depreciation deduction) should be allocated to Carl.

Allocation of Depreciation Recapture

Now we've seen how gains from the sale of contributed property are allocated, and how depreciation deductions on contributed property are allocated. One last related point, and then we'll move on to a new topic.

You will recall (from the Survey course) that when depreciable personal property is sold, the portion of the gain attributable to previously-taken depreciation is taxed at *ordinary* income rates, and the rest of the gain (attributable to an increase in the value of the property) is taxed at *capital gain* rates. Here is the Code provision that does this:

§ 1245. Gain from dispositions of certain depreciable property

(a) General rule.—

- (1) Ordinary income.—Except as otherwise provided in this section, if section 1245 property is disposed of, the amount by which . . . the amount realized . . . exceeds the adjusted basis of such property shall be treated as ordinary income. . . .
- (3) Section 1245 property.—For purposes of this section, the term "section 1245 property" means any property which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is . . . personal property. . . .

Internal Revenue Code §1250 contains a somewhat similar rule for the sale of real property. But for real property, gain attributable to depreciation is taxed at ordinary income rates (rather than at capital gains rates), only if *accelerated* depreciation was taken on that real property; and accelerated depreciation hasn't been permitted on real property since 1986. So for present purposes, we'll just stick with depreciable personal property, such as the equipment that Carl contributed to the partnership.

Read (in Schwarz & Lathrope)

Pages 490-491 (top two lines)

Page 505 (paragraph 4 only)

Regulation provision re Allocation of Depreciation Recapture

Reg. § 1.1245-1

(e) Treatment of partnership and partners.

- . . .
- (2) (i) . . . a partner's distributive share of gain recognized under section 1245(a)(1) by the partnership is equal to the lesser of
 - the partner's share of total gain from the disposition of the property (gain limitation) or
 - the partner's share of depreciation . . . with respect to the property (as determined under paragraph (e)(2)(ii) of this section). . . .
 - (ii)(A) . . . a partner's share of depreciation . . . with respect to property equals the total amount of . . . depreciation . . . previously allocated to that partner with respect to the property.

Question re Allocation of Depreciation Recapture

7. We are now going to revisit Question 4 in Study Guide 6. Here again is a revised version of that question, focusing on the fact that is relevant to depreciation recapture.

During its first year of operation, the partnership discovered that some of the equipment that Carl contributed was not suitable for its business, so it sold the unsuitable equipment, and made \$10,000 profit doing so. All of that profit was the result of the partnership's recapture of depreciation Carl previously took. How will the depreciation recapture be reported by Anne, Beth, Carl and Doug?

The answer that we said was correct – on the basis of the law we had studied to that point – was:

Each partner will report and include in gross income his or her share of the \$10,000 gain from the sale of the equipment.

Is that answer correct?

- a. Yes, that answer is correct, assuming the partners agreed to share partnership income and losses equally. In addition, Carl's share will be taxed to him at ordinary income tax rates, but the shares taxed to Anne, Beth and Doug will be taxed to them at capital gains rates.
- b. No, that answer is not correct. All of the partnership profits will be allocated to Carl and will be taxed to him at capital gains rates.
- c. No, that answer is not correct. All of the partnership profits will be allocated to Carl and will be taxed to him at ordinary income rates.

Note: In answering this question, focus first on how much of the gain must be allocated to Carl by virtue of Code § 704(c) (on page 2 of this Study Guide), and then on Regulation § 1.1245-1(e)(2)(ii) (on page 8 of this Study Guide), and ask yourself this: If the partnership sold the equipment *before* the partnership itself took any depreciation on it, how much depreciation, if any, did the partnership allocate to Anne, Beth and Doug?

- \$0
- Some other amount. (How much?)

If you decide how much of the *recapture* depreciation should be allocated to Carl by subtracting the amount allocated to Anne, Beth and Doug, you'll get the right answer to Question 7.

Study Guide 9

OPERATING A BUSINESS

Operating a Partnership

Taxing Partner-with-Partnership Transactions

Scrutinizing Family Partnerships

Taxing Partner-with-Partnership Transactions

At the very beginning of this course, we briefly considered whether Doug could go into business for himself as a sole proprietor, and could simply borrow money from Anne, lease real estate from Beth, and rent equipment from Carl. We decided that Doug could, and we considered the tax consequences of his doing so, to all four of them. Then we quickly decided that they would form an entity of some sort; and we decided this for two reasons. First, this is a course in the Taxation of Business Entities, so if they didn't form an entity, the course would have been over before the end of the first class meeting. Second, we noted that Anne, Beth and Carl might *want* to own part of Doug's business, especially if they thought it was going to be a big success; and Doug might *want* Anne, Beth and Carl to be co-owners, so they would be compensated as co-owners rather than as creditors, especially if Doug was concerned that the business may not turn a profit as soon as he hoped it would.

In this Study Guide, we will look at yet another reason that Anne, Beth, Carl and Doug may have wanted to structure their relationship as a partnership. That reason (as you may suspect by now) is that partners may be able to enjoy certain tax benefits that sole proprietors and their lenders, landlords and equipment providers cannot. Indeed, though in the preceding paragraph I described the business as "Doug's business," the business may have been Anne's idea, and Beth, Carl and Doug may have been made "partners" for tax rather than business reasons.

The reason there sometimes are tax advantages to be had by being partners is that partnership payments for property and services provided by those who are not partners are treated differently than allocations and distributions for property and services to those who are partners. You've seen this already in Study Guide 2 where you learned that by virtue of Internal Revenue Code § 721, contributing property to a partnership, in return for an ownership interest in the partnership, is not a taxable event

- even if the contributing partner realizes a gain, by contributing property with a basis that is less than the value of the partnership interest received in exchange (as Beth and Carl did), and
- even though the partnership interest received in exchange entitles the partner to an allocation and distribution of a share of the partnership's profits.

In a nutshell, the tax advantages that tempt people to form partnerships, when otherwise they may not have, involve

- delaying a partner's recognition of some income by a year (if the partnership's tax year is different from the partner's tax year),
- shifting the partnership's ordinary income to low-bracket partners and its capital gains to high-bracket partners, and
- reducing the taxable income of some partners, by reducing their shares of the partnership's profits by allocating a share of those profits to a partner who contributes property that, if the property had been purchased by the partnership, would have resulted in no deductions to the partnership at all (if the property were not depreciable, like raw land) or only partial deductions each year (if the property had to be capitalized and depreciated).

In this Study Guide, we will look at provisions of the Code that prevent partnerships and their partners from characterizing payments to partners as "allocations and distributions" if those payments were for services or property and the circumstances show that in substance the transaction was the same as it would have been if services and property had been acquired from someone who wasn't a partner.

Read (in Schwarz & Lathrope)

Pages 521-528*

*Before you begin reading, note that assigned pages begin with an Example, on pages 521-522, which is intended to illustrate the difference between *allocating* \$50,000 to a partner for his or her services, and *paying* the partner \$50,000 for his or her services. Regardless of which way it's done, all of the partners wind up with the same total amount of income. But if it's done as an allocation, the partner who provides services winds up with less ordinary income and more capital gains than if it's done as a payment. Likewise, if it's done as an allocation, the other two partners wind up with more ordinary income and less capital gains than if it's done as a payment. The unstated point behind the Example is that the partner who provided services may have been compensated using an allocation rather than a payment for tax reasons, rather than for economic reasons (or vice versa, I suppose). The Example is intended to show what would happen, if the IRS recharacterized the allocation as a payment, as Code § 707(a) permits it to do.

I mention all this, because it took me longer than it should have to understand the facts and arithmetic of the “allocation” part of the Example. In the “allocation” part of the Example, the numbers make sense if the deal is one in which the \$50,000 “allocation” is not made in cash, but is merely used to determine the service-partner’s percentage of the partnership’s total income, and that percentage is then used to determine how much of the partnership’s ordinary business income and capital gains are allocated to that partner.

Keep that “percentage-not-cash” explanation in mind, as you look at the following chart of both parts of the Example.

Allocation vs. Payment	Partner	Ordinary Business Income	Capital Gains	Total Income
		\$150,000	\$50,000	\$200,000
Allocation	A (for services)	\$50,000		\$50,000
	A (as partner)	\$25,000	\$25,000	<u>\$50,000</u>
	A’s total			\$100,000
	B (as partner)	\$37,500	\$12,500	\$50,000
	C (as partner)	\$37,500	\$12,500	\$50,000
Payment §707(a)	A (for services)	\$50,000		\$50,000
	A (as partner)	\$33,333	\$16,667	<u>\$50,000</u>
	A’s total			\$100,000
	B (as partner)	\$33,333	\$16,667	\$50,000
	C (as partner)	\$33,333	\$16,667	\$50,000

There is a third possible scenario that isn’t mentioned in the Example at all. The third scenario is one in which the service-providing partner is contributing his or her services for his or her share of the partnership’s profits, and is not receiving anything extra for those services. Here is a chart of what that scenario would look like, if the Example had included it.

Allocation vs. Payment	Partner	Ordinary Business Income	Capital Gains	Total Income
		\$150,000	\$50,000	\$200,000
Allocation	A (as partner)	\$50,000	\$16,667	\$66,667
	B (as partner)	\$50,000	\$16,667	\$66,667
	C (as partner)	\$50,000	\$16,667	\$66,667

Internal Revenue Code provision re Partner-with-Partnership Transactions

§ 707. Transactions between partner and partnership

- (a) Partner not acting in capacity as partner
 - (1) In general. If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.
 - (2) Treatment of payments to partners for property or services. Under regulations prescribed by the Secretary -
 - (A) Treatment of certain services and transfers of property. If -
 - (i) a partner performs services for a partnership or transfers property to a partnership,
 - (ii) there is a related . . . allocation and distribution to such partner, and
 - (iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction described in paragraph (1).
 - (B) Treatment of certain property transfers. If -
 - (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,
 - (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and
 - (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.
- . . .
- (c) Guaranteed payments. To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and subject to section 263 [requiring capitalization of certain expenditures], for purposes of section 162(a) (relating to trade or business expenses).

Questions re Partner-with-Partnership Transactions

1. Doug will be working full-time for the partnership. His services will not be the sort that the partnership could obtain from a consultant or independent contractor. What is the likelihood that the IRS would consider Doug's services as being provided by "one who is not a partner," under Code § 707(a)? (The standard used to answer this question is not in the Code or the Regulations. It's described in Schwarz & Lathrope at page 521.)
 - a. Likely.
 - b. Not likely.
2. Suppose that Doug's deal is that: the partnership will allocate and distribute its profits to Anne, Beth and Carl, in equal shares of 33.3% each, until such time as each of the three of them has received \$100,000 in partnership profits; and thereafter, partnership profits will be allocated and distributed to all four partners, Doug included, in equal shares of 25% each. (The partners also agreed that their capital accounts will reflect these allocations and distributions.) In this case, would it matter whether the IRS considered Doug's services as being provided by "one who is not a partner," under Code § 707(a), or would the tax results to everyone be the same, either way?
 - a. It would matter, because the tax results would be different.
 - b. It wouldn't matter, because the tax results would be the same.
3. Suppose that Anne's deal is that the partnership will allocate and distribute 25% of its profits to her, but not less than \$10,000 per year (regardless of whether or not the partnership earns a profit). If the partnership has ordinary business income of \$30,000 for its first year (25% of which is just \$7,500), and the partnership allocates and distributes \$10,000 to Anne as promised, what are the tax consequences?
 - a. Anne's distributive share would be \$7,500 and the remaining \$2,500 would be a guaranteed payment, all of which will be taxable income to Anne. The remaining \$20,000 of partnership income will be allocated equally among Beth, Carl and Doug, so each will have distributive shares of \$6,667, and that is the amount that will be taxable to them.
 - b. Anne's distributive share would be \$7,500 and the remaining \$2,500 would be a guaranteed payment, all of which will be taxable income to Anne. Beth, Carl and Doug each will have distributive shares of \$7,500 (i.e., 25% of the partnership's \$30,000 in income), and that is the amount that will be taxable to them.
4. Suppose that Beth's deal is that: the partnership will allocate and distribute 100% of its profits to her, until she has received \$100,000 in partnership profits; then partnership profits will be allocated equally among Anne, Carl and Doug, 33.3% each, until they have received \$100,000 each; and then partnership profits will be allocated 33% each to Anne, Carl and Doug, and 1% to Beth. (Capital accounts will reflect these allocations and distributions.) What is the likelihood that the IRS would consider the partnership's acquisition of Beth's real estate as having been the result of a transaction "between the partnership and one who is not a partner," under Code § 707(a)? Make a note concerning how and why you came to your conclusion - i.e., what factors did you consider, and how did you apply them?
 - a. Likely.
 - b. Possible.
 - c. Not likely.

5. Assume that the partnership's ordinary business income for its first year is exactly \$100,000, and that all of that profit is allocated and distributed to Beth (in accordance with the agreement described in the preceding question). If the IRS did consider the partnership's acquisition of Beth's real estate as having been the result of a transaction "between the partnership and one who is not a partner," what would the tax consequences be?
- Anne, Carl and Doug will have no taxable income; and Beth will have income of \$100,000.
 - Anne, Carl and Doug will have ordinary income of \$33,333 each; and Beth will have no income.
 - Anne, Carl and Doug will have ordinary income of \$33,333 each; and Beth will have income of \$50,000 (i.e., \$100,000 less her \$50,000 basis in the real estate).
 - There will be no tax consequences at all.

Scrutinizing Family Partnerships

Read (in Schwarz & Lathrope)

Pages 528-529

Internal Revenue Code and Regulation provisions re Family Partnerships

§ 704. Partner's distributive share

(e) Family partnerships

- Recognition of interest created by purchase or gift. A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.
- Distributive share of donee includible in gross income. In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.
- Purchase of interest by member of family. For purposes of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

Regulation § 1.704-1(e)

(3) Allocation of family partnership income—

(i) In general.

(a) Where a capital interest in a partnership in which capital is a material income-producing factor is created by gift, the donee's distributive share shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the distributive share attributable to the donor's capital. . . .

(b) To the extent that the partnership agreement does not allocate the partnership income in accordance with (a) of this subdivision, the distributive shares of the partnership income of the donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (other than a reasonable allowance for the services, if any, rendered by the donee) to the partnership capital of the donor and donee. The portion of income, if any, thus attributable to partnership capital for the taxable year shall be allocated between the donor and donee in accordance with their respective interests in partnership capital.

(c) In determining a reasonable allowance for services rendered by the partners, consideration shall be given to all the facts and circumstances of the business, including the fact that some of the partners may have greater managerial responsibility than others. There shall also be considered the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the partnership.

(ii) Special rules.

(a) The provisions of subdivision (i) of this subparagraph, relating to allocation of family partnership income, are applicable where the interest in the partnership is created by gift, indirectly or directly. . . . This rule may be illustrated by the following examples:

Example 1. A father gives property to his son who shortly thereafter conveys the property to a partnership consisting of the father and the son. The partnership interest of the son may be considered created by gift and the father may be considered the donor of the son's partnership interest.

Questions re Family Partnerships

6. Assume that:

- Anne and Doug are husband and wife, and Beth and Carl are their young children.
- All four own equal 25% interests in the capital of the partnership.
- The real estate and equipment contributed by Beth and Carl were owned originally by their father Doug; and Doug gave Beth and Carl the real estate and equipment as gifts, shortly before Beth and Carl contributed them to the partnership in return for their partnership interests.
- The real estate and equipment are material income-producing factors for the partnership (e.g., the partnership manufactures goods using the equipment which is located in a factory that is the real estate).
- The partnership's profits are allocated among the partners in equal 25% shares, and the 25% allocated to Doug reasonably compensates him for the services he renders to the partnership.

Under these circumstances, will the 25% shares of partnership income allocated to young Beth and Carl be taxable to them, or will their income be reallocated to Anne and Doug?

- a. It will be taxable to young Beth and Carl.
- b. It will be reallocated, and thus taxable to, Anne and Doug.

7. The facts of Question 6 remain the same, with this one exception:

- The partnership's profits are (still) allocated among the partners in equal 25% shares, *but* the 25% allocated to Doug does *not* reasonably compensate him for the services he renders to the partnership. In order to hire someone of Doug's experience and skill, the partnership would have to pay twice as much to someone who was not a partner.

Under these circumstances, will the 25% shares of partnership income allocated to young Beth and Carl be taxable to them, or will their income be reallocated to Doug?

- a. It will be taxable to young Beth and Carl.
- b. As much of Beth and Carl's shares of the partnership's profits as necessary will be reallocated to Doug so that he receives the fair value of his services, and any balance of partnership profits will be allocated to Beth and Carl, 25% each.

8. The facts of Question 6 remain the same, with this one exception:

- The partnership's profits are (still) allocated among the partners in equal 25% shares, *but* Beth and Carl did not own or contribute the real estate and equipment. The real estate and equipment were owned and contributed by Anne and Doug. Instead, Beth contributed a bookcase and Carl contributed a wagon, each of which was worth \$25 and both of which actually are used by the partnership in its business.

Under these circumstances, will the 25% shares of partnership income allocated to young Beth and Carl be taxable to them, or will their income be reallocated to Anne and Doug?

- a. It will be taxable to young Beth and Carl.
- b. A portion (likely large) of Beth and Carl's shares of the partnership's profits will be reallocated to Anne and Doug so that profits are allocated in proportion to the relative values of the contributed real estate, equipment, bookcase and wagon.

Study Guide 10

OPERATING A BUSINESS

Operating a Partnership

Distributing Cash and Property to Partners: Consequences to Partners

Distributing Cash and Property to Partners: Consequences to Partners

Cash Distributions

Most small business partnerships are formed and operated with the expectation (or at least the hope) that they will earn profits, so they can distribute *cash* to their partners. I emphasize the word "cash," because cash is what partners want; but it's not what they're taxed on. Partners are taxed on their shares of the partnership's *profits*, even if those profits are more than the cash that's distributed. Indeed, even if partnership profits are *less* than the amount of cash that's distributed, partners will pay tax on their shares of those lesser profits. As always, there is an exception to this general rule. So now, we'll look at exactly how the general rule works, and when the exception kicks in.

Read (in Schwarz & Lathrope)

Pages 555-557

Internal Revenue Code and Regulation provisions re Consequences to Partners of Cash Distributions

§ 731. Extent of recognition of gain or loss on distribution

- (a) Partners. In the case of a distribution by a partnership to a partner -
- (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and
 - (2) loss shall not be recognized to such partner. . . .

§ 705. Determination of basis of partner's interest

- (a) General rule. The adjusted basis of a partner's interest in a partnership shall . . . be the basis of such interest determined under section 722 (relating to contributions to a partnership) . . . -
- (1) increased by the sum of his distributive share for the taxable year and prior taxable years of -
 - (A) taxable income of the partnership . . . ;
 - (2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of -
 - (A) losses of the partnership. . . .

§ 733. Basis of distributee partner's interest

- In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by -
- (1) the amount of any money distributed to such partner. . . .

Reg. § 1.731-1 Extent of recognition of gain or loss on distribution

(a) Recognition of gain or loss to partner—

(1) Recognition of gain.

...
(ii) For the purposes of sections 731 and 705, *advances or drawings* of money or property *against a partner's distributive share* of income shall be treated as current distributions made on the last day of the partnership taxable year with respect to such partner. (Emphasis added.)

Questions re Consequences to Partners of Cash Distributions

1. In its first year of operations, the partnership formed by Anne, Beth, Carl and Doug earned ordinary business income of \$100,000. Each of the partners has a 25% interest in the partnership. But, at the end of the year, the partnership distributed only \$20,000 in cash to each partner, because it wanted to keep \$20,000 in cash in its bank account to pay routine expenses during the early part of its second year of operations. How much in taxable income will each partner have?
 - a. \$20,000, because that's the amount of cash that was distributed to each partner.
 - b. \$25,000, because that's the amount of each partner's share of the partnership's profits.

2. Recall that although Anne, Beth, Carl and Doug are equal 25% partners, their bases in the partnership aren't equal, because Beth and Carl contributed property in which their basis was less than the value of the property. That is, when the partnership was formed, Anne's and Doug's bases in the partnership were \$100,000 each; but Beth's basis was \$50,000 and Carl's was \$25,000. At the end of the partnership's first year, what were their bases, given the profits and distributions reported in Question 1?
 - a. Their bases remained the same as they were when the partnership was formed.
 - b. All of their bases increased \$25,000 each.
 - c. All of their bases decreased \$20,000 each.
 - d. Both "b" and "c" occurred, so that their bases were increased a net of \$5,000 each: Anne's and Doug's are now \$105,000; Beth's is \$55,000; and Carl's is \$30,000.

3. Assume that although the partnership earned ordinary business income of \$100,000 for its first year, at the end of the year, it distributed \$30,000 in cash to each partner. (This would be a total distribution of \$120,000, but recall that Anne contributed \$100,000 in cash when the partnership was formed; so even though the partnership earned only \$100,000, it could have enough cash on hand to distribute \$120,000.) How much taxable income will each partner have?
 - a. \$30,000, because that's the amount of cash that was distributed to each partner.
 - b. \$25,000, because that's the amount of each partner's share of the partnership's profits.

4. What were the amounts of the partners' bases in the partnership at the end of the first year, as a result of the profits and distributions reported in Question 3?
 - a. Their bases remained the same as they were when the partnership was formed.
 - b. All of their bases increased \$25,000 each.
 - c. All of their bases decreased \$30,000 each.
 - d. Both "b" and "c" occurred, so that their bases were decreased a net of \$5,000 each: Anne's and Doug's are now \$95,000; Beth's is \$45,000; and Carl's is \$20,000.
5. Assume that during its first year, the partnership earned the profits and made the distributions reported in Question 3, and they had the effects on the partner's bases that you determined in answer to Question 4. Now, suppose that during its second year of operations, the partnership's ordinary business income was \$0; that is, it just broke even. If the partnership nevertheless again distributed \$30,000 in cash, at the end of the year, to each of the partners, including Carl, who – as a result of the first year's distribution ended that year with a basis of \$20,000 – what would the tax consequences be to Carl for that second year?
 - a. Carl would not have any taxable income from the partnership for its second year, because 25% of \$0 is \$0, and Doug's taxable income is his share of the partnership's profits, not the amount that was distributed to him.
 - b. Carl would have \$30,000 in taxable income, because that's the amount that was distributed to him.
 - c. Carl would have \$10,000 in taxable income, because that's the amount by which the cash distributed to him exceeded his basis in the partnership.
6. Assume that during its first year, the partnership earned the profits and made the distributions reported in Question 3, and they had the effects on the partner's bases that you determined in answer to Question 4. Now, suppose that during its second year of operations, the partnership's ordinary business income was \$20,000. If the partnership nevertheless again distributed \$30,000 in cash, at the end of the year, to each of the partners, including Carl, who – as a result of the first year's distribution ended that year with a basis of \$20,000 – what would the tax consequences be to Carl for that second year?
 - a. Carl would have \$5,000 in taxable income from the partnership for its second year, because 25% of \$20,000 is \$5,000, and Doug's taxable income is his share of the partnership's profits, not the amount that was distributed to him.
 - b. Carl would have \$30,000 in taxable income, because that's the amount that was distributed to him.
 - c. Carl would have \$10,000 in taxable income: \$5,000 as his share of the partnership's profits, plus another \$5,000 because that's the amount by which the cash distribution he received exceeded his basis in the partnership.

7. The preceding questions all stated that the partnership distributed cash to Anne, Beth, Carl and Doug at the end of the partnership year. Suppose, though, that in Question 6, the \$30,000 cash distributions to each partner were made during the year, at the rate of \$2,500 per month, based on the partnership's estimate of how much profit it would earn for the year. Would that have changed your answer to Question 6?
- No, because cash distributions made during the year are treated by law as though they were made on the last day of the partnership year, which is exactly what was done in Question 6.
 - Yes, it would change my answer, because the \$2,500 monthly cash distribution to Carl during the second year would bring his basis down to \$0 by the end of August, so that the \$2,500 per month distributions for September through December would exceed his basis and would result in \$10,000 income to him. What's more, on top of that \$10,000 in income, he'll have additional taxable income of \$5,000, that being his 25% share of the partnership's \$20,000 in profits.
 - Answer "b" is correct if, but only if, the \$2,500 monthly payments to Carl are *not* "advances" or "drawings" against his share of the partnership's income; and they wouldn't be, only if Carl were *not* obligated to refund to the partnership any cash distributions that exceed his share of the partnership's profits. If Carl *is* obligated to refund cash distributions that exceed his share of profits, then answer "a" is correct.
8. Question 6 didn't ask about the tax consequences to Anne, Beth and Doug. But if it had, would you have changed your answers about them, if the partnership's distributions to them had been made in monthly installments of \$2,500?
- No, because their bases were much bigger than Carl's; and the \$2,500 monthly distributions to them never reduced their bases to \$0.
 - Yes, if they were not obligated to refund excess cash distributions; no, if they were obligated to do so. (I.e., the analysis is the same as it was for Carl.)

Property Distributions

Earlier in the semester, we considered the significance of partners' *capital accounts* in connection with the distribution of partnership assets, including property, if and when the partnership is *liquidated*. Most partnerships don't usually distribute significant amounts of *property*, unless and until they are liquidated. Usually, if a partnership doesn't need specific property any longer, the partnership sells it for cash, and distributes the cash to the partners (or uses it to pay bills). Nevertheless, what is "usually" the case isn't *always* the case. Sometimes, partnerships do distribute property to partners without liquidating – property like old computers, when the partnership buys new computers. Sometimes, partnerships distribute quite valuable property to partners, without liquidating, especially if that property is difficult to sell but is useful to the partners who receive it. Later, in Study Guide 25, we'll look at the tax consequences of distributing property to partners when a partnership is *liquidated*. Now, we're doing to focus on those unusual circumstances when partnerships distribute property to partners, while the partnership is continuing to operate.

Read (in Schwarz & Lathrope)

Pages 557-560

Internal Revenue Code provisions re Consequences to Partners of Property Distributions

§ 733. Basis of distributee partner's interest

In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by -

- ...
- (2) the amount of the basis to such partner of distributed property other than money, as determined under section 732.

§ 732. Basis of distributed property other than money

- (a) Distributions other than in liquidation of a partner's interest
 - (1) General rule. The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in paragraph (2), be its adjusted basis to the partnership immediately before such distribution.
 - (2) Limitation. The basis to the distributee partner of property to which paragraph (1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

§ 735. Character of gain or loss on disposition of distributed property

- ...
- (b) Holding period for distributed property. In determining the period for which a partner has held property received in a distribution from a partnership . . . , there shall be included the holding period of the partnership . . . with respect to such property.

Questions re Consequences to Partners of Property Distributions

In answering the following questions, don't forget to consider the Code sections on page 1 of this Study Guide, as well as those just above.

9. Immediately after the partnership was organized, it used some of the cash contributed by Anne to purchase four computers for \$1,500 each. The partnership wrote off the entire cost of those computers in the year they were purchased, as permitted by Code § 179. Unfortunately, the partnership soon discovered that the computers were not powerful enough to perform the tasks for which they were purchased. As a result, the partnership distributed the computers – one to each partner – and purchased new computers that are powerful enough to do the job. By the time the partnership distributed the computers, they were “used” computers (though they were in perfect condition), and thus their fair market value was only \$500 each. How much income, if any, did the partners have on account of the distribution of computers to them?
 - a. \$1,500 each, that being the original cost of each computer.
 - b. \$500 each, that being the fair market value of each computer at the time it was distributed.
 - c. \$0 each, because distributions of property (generally) do not result in the recognition of gain or loss.
 - d. Each of the partners had a \$1,000 loss, because that is the amount they wasted by buying the wrong computers.

10. Anne didn't need or want the computer that was distributed to her; but Doug wanted a second computer in addition to the one that was distributed to him. As a result, Doug paid Anne \$500 for her computer, and both were happy. How much income, if any, did Anne have to recognize as a result of this transaction? (Note: this question essentially asks you to determine what the partnership's basis in the computer was at the time it distributed the computer to Anne; and what Anne's basis in the computer was at the time she sold it to Doug.)
- a. \$500, because that's the difference between the amount Doug paid and Anne's basis in the computer.
 - b. Nothing, because Doug paid just the fair market value of the computer at the time he bought it.
 - c. Nothing, because that's the difference between the amount Doug paid and Anne's basis in the computer.
 - d. She had a \$1,000 loss, because that's the difference between the amount Doug paid and Anne's basis in the computer.

Study Guide 11

OPERATING A BUSINESS

Operating a Partnership

Distributing Cash and Property to Partners: Consequences to Partnership
Taxing Fringe Benefits
Paying Payroll Taxes

Distributing Cash and Property to Partners: Consequences to Partnership

The law concerning the tax consequences to a partnership when it distributes cash or property to its partners, while continuing to do business (i.e., without liquidating), comes as close to gibberish – at least upon first and second readings – as anything in the Internal Revenue Code. The reason for this is that the Code is an English-language statement of a series of math formulas that are designed to do a couple of things that are simple in concept but complicated to implement.

First, the formulas – and thus the Code – are designed to permit partnerships to distribute property to their partners without requiring *the partnership* to recognize taxable gain. This objective is a companion to the objective we saw in Study Guide 10, where we looked at Code provisions designed to permit partnerships to distribute property to their partners without requiring the *partners* to recognize taxable gain, *at that time*.

Second, I emphasized the phrase “at that time” in the preceding sentence, because Congress did *not* intend to give up collecting taxes *forever* in connection with property distributions from partnerships. Instead, Congress merely intended to permit partners to postpone the payment of taxes on distributed property until it is converted into cash by its eventual sale (or into a different kind of property by its eventual exchange).

Of course, by now you know that postponing the payment of taxes is so attractive that taxpayers pay their tax lawyers very nice money just to conjure up ways to do that, for as much time as legally possible. Partnerships are particularly good tools for postponing the payment of taxes, so Congress has included provisions in the Code that are designed to prevent taxpayers from abusing the privilege.

Nonrecognition of Gain or Loss

The basic rule – and the one that’s easiest to state and understand – is that partnerships do not recognize gain or loss when they distribute property to their partners (while continuing to operate). Here’s the Code section that does that.

§ 731. Extent of recognition of gain or loss on distribution

(b) Partnerships. No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.

This provision of the Code is easy enough to understand, and so would not be gibberish, by itself. “But wait, there’s more!” And now we’ll look at the “more.”

Impact on Partnership's Inside Basis

There is a related Code provision (related, that is, to § 731(b)), and it tells us two things:

- After a partnership distributes property, the basis of any *remaining* partnership property (notice the words “undistributed partnership property” in the section’s title) generally is *not* adjusted.
- Although the partnership’s basis in its remaining property generally is not adjusted, it will be adjusted if a section 754 election is in effect.

Here is the Code section that does that.

§ 734. Optional adjustment to basis of undistributed partnership property

- (a) General rule. The basis of partnership property shall not be adjusted as the result of a distribution of property to a partner unless the election, provided in section 754 (relating to optional adjustment to basis of partnership property), is in effect with respect to such partnership. . . .

You noticed, I’m sure, that so far we have no idea

- what a “section 754 election” is, or
- when and why a partnership would make such an election.

Let’s start with what a “section 754 election” is. Here are the sections that purport to explain that. (The Code sections referred to in what follows – §§ 731(a), 732(a)(2) and 731(a)(2) – are in Study Guide 10.)

§ 754. Manner of electing optional adjustment to basis of partnership property

If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734. . . .

§ 734. Optional adjustment to basis of undistributed partnership property

- . . .
- (b) Method of Adjustment.— In the case of a distribution of property to a partner by a partnership with respect to which the election provided in section 754 is in effect . . . , the partnership shall-
- (1) increase the adjusted basis of partnership property by -
- (A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1), and
- (B) in the case of distributed property to which section 732(a)(2) . . . applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution . . . over the basis of the distributed property to the distributee, as determined under section 732. . . .

If your instinctive reaction to the two sections excerpted above was the same as my instinctive reaction, you thought: "Huh?" (Among other things, I can't resist pointing out that these provisions lead a trail through the Code that goes backwards: from section 754 back to section 734 and then back to sections 731 and 732. This point, though, is just me being flippant.)

In plain English, these Code sections say that *if* a partnership files an election (as authorized by section 754), the partnership's basis in any property remaining after the partnership distributes other property to its partners shall be increased by

- whatever gain partners recognized as a result of the distribution of *money* to them in excess their basis in the partnership (§ 731(a)),
or
- the difference between
 - the partnership's basis in the *property* it distributed, and
 - the basis of that property in the hands of the partners to whom it was distributed which is a difference that would exist *if* the basis of property distributed to partners exceeded their basis in the partnership, and thus their basis in the distributed property was limited to the amount of their partnership basis (§ 732(a)(2)).

So that's *what* a "section 754 election" is. Now all we need to know is when and why a partnership would make one. The Code, of course, doesn't explain *that*.

The Examples in the next reading assignment (at pages 564-567) illustrate the consequences of making or not making a section 754 election. And those consequences are these:

Distribution of cash to a partner

- *Partnership has not made a 754 election*

If cash is distributed to a partner in an amount that exceeds the partner's basis in the partnership, and no election was made, the partnership's basis in its remaining assets will remain unchanged. Therefore, if the partnership later sells those assets at a gain, all of that gain will be allocated among (and will be taxable to) the partners, *even though* the partner who earlier received cash already paid tax on some of that gain.

- *Partnership has made a 754 election*

If cash is distributed to a partner (etc.), and the partnership did make an election, the partnership's basis in the remaining assets will be increased by the amount of the gain already recognized by the partner who got the cash. Therefore, if the partnership later sells those assets at a gain, the gain will be smaller (higher basis = smaller gain), and thus the gain allocated among the partners (on which they will be taxed) will be smaller.

Distribution of property to a partner

- *Partnership has not made a 754 election*

If property is distributed to a partner, and the partnership's basis in that property is greater than the partner's basis in the partnership, the receiving partner's basis in the property will be limited to his or her basis in the partnership. If the partnership did not make an election, the partnership's basis in its remaining assets will remain unchanged. Therefore, if the partnership later sells those assets at a gain, all of that gain will be allocated among (and will be taxable to) the partners, *even though* the partner who earlier received property in which he or she has a lower basis, will eventually pay tax (when he or she sells that property) on some of that same gain.

- *Partnership has made a 754 election*

If property is distributed to a partner, and the partnership's basis in that property is greater than the partner's basis in the partnership, the receiving partner's basis in the property will be limited to his or her basis in the partnership. If the partnership did make an election, the partnership's basis in its remaining assets will be increased. Therefore, if the partnership later sells those assets at a gain, the gain will be smaller (higher basis = smaller gain), and thus the gain allocated among the partners (on which they will be taxed) will be smaller.

The thing that isn't well explained in the preceding paragraphs is why – if no election is made – the partner who received a distribution winds up paying tax on the same gain that later gets allocated to the partners when the partnership sells the remaining assets. To see that, you have to look at the balance sheets in the Examples in the reading assignment.

In any event, what the foregoing paragraphs mean (it seems to me) is that a 754 election should be made, whenever the partnership intends to distribute

- cash to a partner in an amount that exceeds his or her partnership basis, or
- property to a partner, in which the partnership's basis exceeds the partner's basis in the partnership

in order to minimize the gain (or maximize the loss) the partnership will realize on the later sale of its remaining assets. Read the following assignment, and see whether you agree.

Read (in Schwarz & Lathrope)

Pages 563-567 (up to paragraph "3")

Questions re Partnership Distributing Cash and Property to Partners: Consequences to Partnership

1. Here is the balance sheet of the partnership formed by Anne, Beth, Carl and Doug, as the balance sheet read immediately after the partnership was formed.

<u>ASSETS</u>			<u>LIABILITIES/PARTNERS' CAPITAL</u>		
	<u>Adj Basis</u>	<u>Book Value</u>		<u>Adj. Basis</u>	<u>Book Value</u>
Cash	\$100,000	\$100,000	Liabilities	\$0	\$0
Real Estate	\$ 50,000	\$100,000	Capital		
Equipment	\$ 25,000	\$100,000	Anne	\$100,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Beth	\$ 50,000	\$100,000
Total	\$275,000	\$400,000	Carl	\$ 25,000	\$100,000
			Doug	<u>\$100,000</u>	<u>\$100,000</u>
			Totals	\$275,000	\$400,000

During its first year, the partnership distributed \$100,000 in cash to Carl (though none to anyone else), thereby liquidating his interest in the partnership (so he's no longer a partner). If the partnership did nothing else at all that first year (and thus had no gains or losses), how much income would Carl have to recognize and report on his own tax return?

- a. Nothing, because partners, including Carl, are taxed on their shares of partnership income, not on what is distributed to them.
 - b. \$75,000, because that is the amount by which the \$100,000 distributed to him exceeded his \$25,000 basis in the partnership.
2. Is the following an accurate balance sheet for the partnership (as of the end of the year in which it distributed \$100,000 to Carl, but did nothing else), if the partnership did *not* make a section 754 election?

<u>ASSETS</u>			<u>LIABILITIES/PARTNERS' CAPITAL</u>		
	<u>Adj Basis</u>	<u>Book Value</u>		<u>Adj. Basis</u>	<u>Book Value</u>
Cash	\$ 0	\$ 0	Liabilities	\$0	\$0
Real Estate	\$ 50,000	\$100,000	Capital		
Equipment	\$ 25,000	\$100,000	Anne	\$100,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Beth	\$ 50,000	\$100,000
Total	\$175,000	\$300,000	Doug	<u>\$100,000</u>	<u>\$100,000</u>
			Totals	\$250,000	\$300,000

- a. Yes, this is accurate, even though it shows an adjusted basis for the Assets of only \$175,000 while the adjusted basis for the partners' capital accounts is \$250,000.
- b. No, this is not accurate, because the adjusted basis of the Assets is only \$175,000 while the adjusted basis of the partners' capital accounts is \$250,000.

3. During the partnership's second year, it sold the equipment (that former-partner Carl originally contributed) for \$100,000. If the balance sheet in Question 2 is accurate, how much gain will the partnership realize from that sale, and allocate among Anne, Beth and Doug?
 - a. \$75,000 which will be allocated among Anne, Beth and Doug, each of whom will have to recognize and report his or her share on his or her own tax return.
 - b. No gain, because Carl already recognized and reported that \$75,000 gain on his tax return.
4. Is the following an accurate balance sheet for the partnership (as of the end of the year in which it distributed \$100,000 to Carl, but did nothing else), if the partnership *did* make a section 754 election?

<u>ASSETS</u>			<u>LIABILITIES/PARTNERS' CAPITAL</u>		
	<u>Adj Basis</u>	<u>Book Value</u>		<u>Adj. Basis</u>	<u>Book Value</u>
Cash	\$ 0	\$ 0	Liabilities	\$0	\$0
Real Estate	\$ 50,000	\$100,000	Capital		
Equipment	\$100,000	\$100,000	Anne	\$100,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Beth	\$ 50,000	\$100,000
Total	\$250,000	\$300,000	Doug	<u>\$100,000</u>	<u>\$100,000</u>
			Totals	\$250,000	\$300,000

- a. Yes, this is accurate, because it shows a \$75,000 increase in the adjusted basis for the equipment (that former-partner Carl originally contributed).
 - b. No, this is not accurate, because the partnership's adjusted basis for the equipment should be only \$25,000.
5. During the partnership's second year, it sold the equipment (that former-partner Carl originally contributed) for \$100,000. If the balance sheet in Question 4 is accurate, how much gain will the partnership realize from that sale, and allocate among Anne, Beth and Doug?
 - a. \$75,000 which will be allocated among Anne, Beth and Doug, each of whom will have to recognize and report his or her share on his or her own tax return.
 - b. No gain, because the partnership's adjusted basis in the equipment was the same amount as the amount the partnership realized when it sold the equipment.
6. In Questions 1 through 5, the partnership distributed cash to Carl, and it kept the equipment he had contributed. Suppose that instead of giving Carl cash, the partnership distributed to him the real estate (originally contributed by Beth), thereby liquidating his interest in the partnership (so he's no longer a partner). If the partnership did nothing else at all that first year (and thus had no gains or losses), how much income would Carl have to recognize and report on his own tax return?
 - a. Nothing, because partners, including Carl, are taxed on their shares of partnership income, not on what is distributed to them.
 - b. \$75,000, because that is the amount by which the fair market (book) value of the real estate distributed to him exceeded his \$25,000 basis in the partnership.

7. If instead of giving Carl cash, the partnership distributed to him the real estate (originally contributed by Beth), what would Carl's basis be in the real estate?
- \$100,000, which is the fair market value (book value) of the real estate, and the amount of Carl's capital account, just before his interest was liquidated.
 - \$50,000, which is what the partnership's basis in the real estate was.
 - \$25,000, which is what Carl's basis in his interest in the partnership was, just before his interest was liquidated, even though \$25,000 is less than what the partnership's basis in the real estate was.
8. Is the following an accurate balance sheet for the partnership (as of the end of the year in which it distributed the real estate to Carl, but did nothing else), if the partnership did *not* make a section 754 election?

<u>ASSETS</u>			<u>LIABILITIES/PARTNERS' CAPITAL</u>		
	<u>Adj Basis</u>	<u>Book Value</u>		<u>Adj. Basis</u>	<u>Book Value</u>
Cash	\$100,000	\$100,000	Liabilities	\$0	\$0
Real Estate	\$ 0	\$ 0	Capital		
Equipment	\$ 25,000	\$100,000	Anne	\$100,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Beth	\$ 50,000	\$100,000
Total	\$225,000	\$300,000	Doug	<u>\$100,000</u>	<u>\$100,000</u>
			Totals	\$250,000	\$300,000

- Yes, this is accurate, even though it shows an adjusted basis for the Assets of only \$225,000 while the adjusted basis for the partners' capital accounts is \$250,000.
 - No, this is not accurate, because the adjusted basis of the Assets is only \$225,000 while the adjusted basis of the partners' capital accounts is \$250,000.
9. During the partnership's second year, it sold the equipment (that former-partner Carl originally contributed) for \$100,000. If the balance sheet in Question 8 is accurate, how much gain will the partnership have to recognize from that sale, and allocate among Anne, Beth and Doug?
- \$75,000 which will be allocated among Anne, Beth and Doug, each of whom will have to recognize and report his or her share on his or her own tax return.
 - No gain, because if Carl were to sell the real estate for the \$100,000 it was worth when it was distributed to him, he will have to recognize a \$75,000 gain.

10. Is the following an accurate balance sheet for the partnership (as of the end of the year in which it distributed the real estate to Carl, but did nothing else), if the partnership *did* make a section 754 election?

<u>ASSETS</u>			<u>LIABILITIES/PARTNERS' CAPITAL</u>		
	<u>Adj Basis</u>	<u>Book Value</u>		<u>Adj. Basis</u>	<u>Book Value</u>
Cash	\$100,000	\$100,000	Liabilities	\$0	\$0
Real Estate	\$ 0	\$ 0	Capital		
Equipment	\$ 50,000	\$100,000	Anne	\$100,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Beth	\$ 50,000	\$100,000
Total	\$250,000	\$300,000	Doug	<u>\$100,000</u>	<u>\$100,000</u>
			Totals	\$250,000	\$300,000

- a. Yes, this is accurate, because it shows a \$25,000 increase in the adjusted basis for the equipment (that former-partner Carl originally contributed) – \$25,000 being the difference between the partnership’s basis in the real estate it distributed to Carl, and the real estate’s \$25,000 basis in Carl’s hands.
- b. No, this is not accurate, because the partnership’s adjusted basis for the equipment should be only \$25,000.
11. During the partnership’s second year, it sold the equipment (that former-partner Carl originally contributed) for \$100,000. If the balance sheet in Question 10 is accurate, how much gain will the partnership realize from that sale, and allocate among Anne, Beth and Doug?
- a. \$50,000 which will be allocated among Anne, Beth and Doug, each of whom will have to recognize and report his or her share on his or her own tax return.
- b. No gain, because Carl will have a greater gain on his sale of the real estate (\$100,000 - \$25,000 = \$75,000 gain to him) than the partnership would have had if it had sold the real estate (\$100,000 - \$50,000 = \$50,000).
12. Did you notice that if
- the answer to Question 11 is “a” and
 - Carl sells the real estate for \$100,000, and
 - the partnership sells the equipment for \$100,000
- the total gain (on which taxes will have to be paid) will be \$125,000, consisting of
- \$75,000 in gain as a result of Carl’s sale of the real estate, and
 - \$50,000 in gain as a result of the partnership’s sale of the equipment,
- and that \$125,000 is also the amount of gain that would have been realized if the partnership sold
- the equipment for \$100,000, and
 - the real estate for \$100,000?
- a. I didn’t notice it until I read this question.
- b. I don’t see it, even now.
- c. Yes, I saw it immediately, but I still don’t see why anyone should care.
- d. Yes, I saw it immediately, and I recognized in this the genius (or at least the Zen) of the International Revenue Code. In fact, this makes me want to become a tax lawyer (or a Monk).

Taxing Fringe Benefits

The tax treatment of fringe benefits provided by partnerships to their partners is not covered in Schwarz & Lathrop (or in their casebook). It is, however, a very important and quite practical topic.

You'll recall (from the Survey course) that *certain* fringe benefits provided by employers to their employees are *not* taxable income to employees. Here are *some* of the Code sections that make this so.

§ 106. Contributions by employer to accident and health plans

- (a) General rule.—Except as otherwise provided in this section, gross income of an employee does not include employer-provided coverage under an accident or health plan.

§119. Meals or lodging furnished for the convenience of the employer

- (a) Meals and lodging furnished to employee, his spouse, and his dependents, pursuant to employment.—There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him, his spouse, or any of his dependents by or on behalf of his employer for the convenience of the employer, but only if—
- (1) in the case of meals, the meals are furnished on the business premises of the employer, or
 - (2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.

§ 132. Certain fringe benefits

- (a) Exclusion from gross income.—Gross income shall not include any fringe benefit which qualifies as a—
- (1) no-additional-cost service,
 - (2) qualified employee discount,
 - (3) working condition fringe,
 - (4) de minimis fringe,
 - (5) qualified transportation fringe,
 - (6) qualified moving expense reimbursement,
 - (7) qualified retirement planning services, or
 - (8) qualified military base realignment and closure fringe.

Although these benefits are not income to employees, the cost of providing those benefits *is* deductible by employers. Here's the Code section that makes that so.

§ 162. Trade or business expenses

- (a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . .

This means that when fringe benefits (listed in the Code section above) are provided by partnerships to their *non*-partner employees

- those benefits are not taxable income to the non-partner employees, and
- the cost of providing those benefits is deductible by the employer-partnership; and the deduction for the cost of those benefits reduces the partnership's ordinary business income that is allocated and taxable to the partners.

The question to be considered now is whether fringe benefits provided to *partners* by partnerships also are tax-free to the partners, while still being deductible by the partnership in calculating the partnership's ordinary business income. This turns out to be a surprisingly difficult question to answer. See what you make of the following.

Revenue Ruling and Internal Revenue Code provision re Taxing Fringe Benefits

**Internal Revenue Service
Revenue Ruling 91-26
EMPLOYEE FRINGE BENEFITS . . . PARTNERSHIPS**

. . .

ISSUES

1. If a partner performs services in the capacity of a partner and the partnership pays accident and health insurance premiums for current year coverage on behalf of such partner without regard to partnership income, what is the Federal income tax treatment of the premium payments?

FACTS

. . . AB is a partnership in which individuals A and B are equal partners. During 1989, AB paid accident and health insurance premiums for 1989 coverage on behalf of each partner under AB's accident and health plan.

The premiums paid by AB on behalf of A and B were for services rendered by A and B in their capacities as partners and were payable without regard to partnership income. The premiums paid by AB would qualify as ordinary and necessary business expenses under section 162(a) of the Code if paid by AB on behalf of individuals who were not partners of AB. The value of the premiums to A and B is equal to the cost of the premiums paid on behalf of A and B, respectively.

. . .

LAW AND ANALYSIS

Section 106 of the Code excludes from the gross income of an employee coverage provided by an employer under an accident or health plan.

Section 162(l) of the Code allows as a deduction, in the case of an individual who is an employee within the meaning of section 401(c)(1) [i.e., self-employed individuals], . . . the amount paid during the taxable year for insurance that constitutes medical care for the individual and the individual's spouse and dependents. . . .

Section 401(c)(1) of the Code treats certain self-employed individuals as employees. Section 401(c)(1)(B) defines a "self-employed individual," with respect to any taxable year, as an individual who has earned income (as defined in section 401(c)(2)) for the taxable year. Section 401(c)(2) defines "earned income" as, in general, the net earnings from self-employment as defined in section 1402(a). Under section 1402(a), the term net earnings from self-employment is defined to

include, with certain specified exceptions, a partner's distributive share of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership in which the individual is a partner. Guaranteed payments to a partner for services also are included in net earnings from self-employment.

...

Section 707(c) of the Code provides that payments to a partner for services, to the extent the payments are determined without regard to the income of the partnership, are considered as made to one who is not a member of the partnership, but only for purposes of section 61(a) (relating to gross income) and . . . for purposes of section 162(a) (relating to trade or business expenses). These payments are termed "guaranteed payments."

Section 1.707-1(c) of the Income Tax Regulations provides that for a guaranteed payment under section 707(c) of the Code to be deductible by the partnership, it must meet the same tests under section 162(a) as it would if the payment had been made to a person who was not a member of the partnership. . . .

Amounts paid . . . by a partnership, without regard to its income, to or for the benefit of its partners, for services rendered in their capacities as partners, are guaranteed payments under section 707(c) of the Code. A partnership is entitled to deduct such cash amounts, or the cost to the partnership of such in-kind benefits, under section 162(a). . . . Under section 61(a), the cash amount or the value of the benefit is included in the income of the recipient-partner. The cash amount or value of the benefit is not excludible from the partner's gross income under the general fringe benefit rules (*except to the extent the Code provision allowing exclusion of a fringe benefit specifically provides that it applies to partners* [emphasis added]) because the benefit is treated as a distributive share of partnership income under section 1.707-1(c) of the regulations for purposes of all Code sections other than sections 61(a) and 162(a), and a partner is treated as self-employed to the extent of his or her distributive share of income. Section 1402(a). See also Rev. Rul. 69-184, 1969-1 C.B. 256 (employment taxes); cf. section 401(c), which recognizes that partners are self-employed individuals but treats them as employees for certain limited purposes.

Therefore, AB may deduct under section 162(a) of the Code . . . the cost of the accident and health insurance premiums paid on behalf of A and B. A and B may not exclude the cost of the premiums from their gross income under section 106, but must include the cost of the premiums in gross income under section 61(a). Provided all the requirements of section 162(l) are met, however, A and B may deduct the cost of the premiums. . . .

You noticed, I hope, that Revenue Ruling 91-26 stated (in the italicized parenthetical above) that partners are *not* permitted to exclude benefits "under the general fringe benefit rules" *unless* the Code provision that permits an exclusion "specifically provides that it applies to partners." Section 106(a), which permits employees to exclude the value of employer-provided health insurance, does not contain language making it applicable to partners. However, according to IRS Publication 15-B, titled "Employer's Tax Guide to Fringe Benefits," partners are permitted to exclude employee discounts and no-additional-cost services (both listed in § 132(a) above), as well as on-site athletic facilities, dependent care assistance, and educational assistance (all in the Code, but not reproduced above). Try as I did (on a Saturday evening), I wasn't able to put my finger on the specific Code subsections that permit partners to exclude those benefits (though I trust that Publication 15-B is accurate and the necessary exclusion language is in the Code somewhere).

§ 162. Trade or business expenses

(l) Special rules for health insurance costs of self-employed individuals. —

(1) Allowance of deduction. —

(A) In general. — In the case of an individual who is an employee within the meaning of section 401(c)(1), there shall be allowed as a deduction under this section an amount equal to the applicable percentage of the amount paid during the taxable year for insurance which constitutes medical care for the taxpayer, his spouse, and dependents.

(B) Applicable percentage. — For purposes of subparagraph (A), the applicable percentage shall be determined under the following table:

For taxable years beginning in calendar year -	The applicable percentage is -
...	
2003 and thereafter	100.

§401(c) Definitions and rules relating to self-employed individuals. . .

(1) Self-employed individual treated as employee

(A) In general. The term "employee" includes, for any taxable year, an individual who is a self-employed individual for such taxable year.

(B) Self-employed individual. The term "self-employed individual" means, with respect to any taxable year, an individual who has earned income (as defined in paragraph (2)) for such taxable year. . . .

(2) Earned income

(A) In general. The term "earned income" means the net earnings from self-employment (as defined in section 1402(a)). . . .

§ 1402. Definitions

(a) Net earnings from self-employment

The term "net earnings from self-employment" means

- the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business,
plus
- his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) [i.e., ordinary business income] from any trade or business carried on by a partnership of which he is a member;

except that

- in computing . . . such distributive share of partnership ordinary income or loss . . .

(13) there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, *other than* guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services. . . .

[Paragraph formatting and italics added.]

§ 707. Transactions between partner and partnership

- ...
- (c) Guaranteed payments. To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and subject to section 263 [requiring capitalization of certain expenditures], for purposes of section 162(a) (relating to trade or business expenses).

Here are those Code sections in plain (or at least plainer) English:

IRC § 162(l)

A "self-employed individual" may deduct health insurance costs (above-the-line, rather than below-the-line which is the only way employees may deduct health insurance costs)

IRC § 401(c)

A partner who has "self-employment earnings" is a "self-employed individual."

IRC § 1402(a)

- "Self-employment earnings" means distributive share of general partnership income.
- "Self-employment earnings" does not mean distributive share of limited partnership income
 - o unless the distributive share includes guaranteed payments for services actually rendered
 - o in which case the guaranteed payments are "self-employment earnings."

IRC § 707(c)

Guaranteed payments made to a partner for services and for the use of capital are treated like payments to a nonpartner for the purpose of deducting business expenses.

To see where all this gets us, try your hand at the following questions.

Questions re Taxing Fringe Benefits

13. If the partnership provides and pays for health insurance for Doug, will the cost of that insurance be deductible by the partnership, when it calculates its ordinary business income; and will the cost be income to Doug?
- a. The partnership will be able to deduct the cost, and the cost will not be income to Doug.
 - b. The partnership will be able to deduct the cost; the cost will be gross income to Doug; but Doug will be able to deduct the cost from his income (so the net effect will be same as if the health insurance were not income to him).
 - c. The partnership will not be able to deduct the cost; but the cost will not be income to Doug.
 - d. The partnership will not be able to deduct the cost; the cost will be gross income to Doug; but Doug will be able to deduct the cost from his income (so the net effect will be the same as if the health insurance were not income to him).

14. If the partnership provides and pays for health insurance for Anne, Beth and Carl (who do *not* provide *services* to the partnership, so the health insurance is in return for the use of their capital), what will the tax consequences to the partnership, and to Anne, Beth and Carl, be the same or different than if the partnership provides insurance to Doug?
- The same, because even Anne, Beth and Carl are "self-employed" for the purpose of § 162(l).
 - Different, because Anne, Beth and Carl are not "self-employed" for the purpose of § 162(l).
15. If the partnership provides educational assistance for Doug, will that assistance be deductible by the partnership, when it calculates its ordinary business income; and will it be income to Doug?
- The partnership will be able to deduct the assistance, and the assistance will not be income to Doug.
 - The partnership will be able to deduct the assistance; the assistance will be gross income to Doug; but Doug will be able to deduct the assistance from his income (so the net effect will be same as if the assistance were not income to him).
 - The partnership will not be able to deduct the assistance; but the assistance will not be income to Doug.
 - The partnership will not be able to deduct the assistance; the assistance will be gross income to Doug; but Doug will be able to deduct the assistance from his income (so the net effect will be the same as if the health insurance were not income to him).

Paying Payroll Taxes

The treatment of payroll taxes is another very important and practical topic not covered in Schwarz & Lathrop (or in their casebook). Payroll taxes are Social Security and Medicare taxes – what Code § 1401 (see below) calls "Old-age, survivors, and disability insurance" (Social Security) and "Hospital insurance" (Medicare). Employees pay Social Security taxes of 6.2% of their wages, which are withheld from their wages, from the first dollar to \$106,800 (for 2009); and employers pay an additional 6.2% of employee wages (again, from the first dollar to \$106,800). Employees pay Medicare taxes of 1.45% of their wages, which are withheld from their wages, from the first dollar (without limit); and employers pay an additional 1.45% of employee wages (from the first dollar, without limit).

Self-employed taxpayers don't have employers to pay the "employer's share." So the self-employed pay 12.4% for Social Security and 2.9% for Medicare. Here's the Code section.

§ 1401. Rate of tax

(a) Old-age, survivors, and disability insurance

In addition to other taxes, there shall be imposed for each taxable year, on the self-employment income of every individual, a tax equal to the following percent of the amount of the self-employment income for such taxable year: . . . 12.40 [percent]

(b) Hospital insurance

In addition to the tax imposed by the preceding subsection, there shall be imposed for each taxable year, on the self-employment income of every individual, a tax equal to the following percent of the amount of the self-employment income for such taxable year: . . . 2.90 [percent].

(Social Security tops off for the self-employed at \$106,800, just as it does for employees.)

Combine § 1401 (above) with § 401(c) and § 1402 (on page 11.12 of this Study Guide), and answer the following questions.

Questions re Payroll Taxes

16. If the partnership is a *general* partnership and it allocates \$25,000 of its ordinary business income to Doug in return for his services, but it distributes only \$20,000 in cash to him, how much Social Security and Medicare taxes will Doug have to pay?

- a. \$1,550 in Social Security taxes (6.2% of \$25,000) and \$362.50 in Medicare taxes (1.45% of \$25,000).
- b. \$1,240 in Social Security taxes (6.2% of \$20,000) and \$290 in Medicare taxes (1.45% of \$20,000).
- c. \$3,100 in Social Security taxes (12.4% of \$25,000) and \$725 in Medicare taxes (2.9% of \$25,000).
- d. \$2,480 in Social Security taxes (12.4% of \$20,000) and \$580 in Medicare taxes (2.9% of \$20,000).

17. If the partnership is a *general* partnership, and it allocates \$25,000 of its ordinary business income to Anne, Beth and Carl (who do not render services to the partnership), but it distributes only \$20,000 in cash to each of them, will they pay the same amount in Social Security and Medicare taxes as Doug?

- a. Yes.
- b. No, they won't have to pay any Social Security and Medicare taxes.

18. If the partnership is a *limited* partnership and it allocates \$25,000 of its ordinary business income to Doug, who is a *limited* partner, *in return for his services*, and that payment is a guaranteed payment, but the partnership distributes only \$20,000 in cash to him, how much Social Security and Medicare taxes will Doug have to pay?
- a. \$1,550 in Social Security taxes (6.2% of \$25,000) and \$362.50 in Medicare taxes (1.45% of \$25,000).
 - b. \$1,240 in Social Security taxes (6.2% of \$20,000) and \$290 in Medicare taxes (1.45% of \$20,000).
 - c. \$3,100 in Social Security taxes (12.4% of \$25,000) and \$725 in Medicare taxes (2.9% of \$25,000).
 - d. \$2,480 in Social Security taxes (12.4% of \$20,000) and \$580 in Medicare taxes (2.9% of \$20,000).
19. If the partnership is a *limited* partnership, and it allocates \$25,000 of its ordinary business income to Anne, Beth and Carl, all of whom are limited partners and do *not* render services to the partnership, but it distributes only \$20,000 in cash to each of them, will they pay the same amount in Social Security and Medicare taxes as Doug?
- a. Yes.
 - b. No, they won't have to pay any Social Security and Medicare taxes.
20. Half the amount that self-employed taxpayers pay in Social Security and Medicare taxes is deductible by them above-the-line, on their own tax returns. (See Form 1040, Line 27, a copy of which is at the end of these Study Guides.) This means that half the amount paid in such taxes by the self-employed reduces their taxable income, dollar-for-dollar, even if they don't itemize their deductions. Does this deduction mean that employees and the self-employed wind up paying the same amount in Social Security and Medicare taxes after all?
- a. Yes.
 - b. No, the self-employed still wind up paying more than employees.

Study Guide 12

OPERATING A BUSINESS

Operating a C Corporation

Taxing Corporate Operations

Taxing Corporate Operations

The reading assignment for this Study Guide provides some details (many, actually) concerning the way in which C corporations are taxed on their day-to-day operations. For our purposes, in this course, those details are at least adequate and may even be more than is necessary.

It's necessary to know that C corporations file tax returns (Form 1120, a copy of which is at the end of these Study Guides) and pay taxes on their profits themselves. C corporation shareholders do not pay taxes themselves on the corporation's profits. As a result, in the classes we devote to the taxation of C corporation operations, we will not be wrestling with things like allocations and distributions and capital accounts, as we had to when we covered taxation of partnership operations.

As you'll see when you read the following assignment, the taxable income of C corporations is calculated in a manner that is quite like the calculation of the taxable income of sole proprietorships, so what you learned about sole proprietorships in the Survey course will be useful now too. There are some differences, and the reading assignment provides some detail concerning those differences. In class, I'll have a few comments to make (by lecture). But my comments won't add more details; they'll put the book's details in a broader context, in the hope that I'll be able to give you some sense of what is really going on, in the Code sections that deal with the operations of corporations.

This Study Guide doesn't have any questions, because insofar as the taxation of corporate earnings is concerning, what you learned in the Survey course and will glean from a quick reading of the following assignment will be sufficient for our purposes.

Read (in Schwarz & Lathrope)

Pages 107-116

Study Guide 13

OPERATING A BUSINESS

Operating a C Corporation

- Taxing Dividends and Other Distributions
 - Taxing Fringe Benefits
 - Paying Payroll Taxes
-

Taxing Dividends and Other Distributions

Now we'll look at what happens, tax-wise, when a corporation pays "dividends" or makes other "distributions" to its shareholders. I put "dividends" and "distributions" in quotation marks, because they are quite specific things, in tax law. Shareholders sometimes (quite often, in fact) receive money from their corporations which is neither a "dividend" nor a "distribution." For example, shareholders who are employed by their corporations are paid salaries for their services, and those salaries are not "dividends" or "distributions." Shareholders who lend money to their corporations receive interest, and those interest payments are not "dividends" or "distributions." And shareholders who lease property or equipment to their corporations receive rental payments which are not "dividends" or "distributions" either.

So, the first thing we'll want to be clear about is what sorts of payments by corporations to shareholders are "dividends" or "distributions." Then, we'll want to know what tax consequences – to shareholders, and to corporations themselves – flow from the payment of "dividends" or "distributions."

What is a "dividend"?

In a nutshell, a dividend is

- a distribution of cash or property by a corporation
- to its shareholders
- because they are shareholders (i.e., not as employees, lenders or landlords)
- out of the corporation's earnings and profits.

Here is the Code section that makes this so:

§ 316. Dividend defined

- (a) General rule. For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders -
 . . . out of its earnings and profits. . . .

Notice that money or property received by shareholders from their corporations are "dividends" only if the money or property comes out of the corporation's "earnings and profits." If the distribution didn't come out of "earnings and profits," it's not a "dividend"; it's something else.

Why does it matter whether a distribution is a “dividend” or something else?

There are several reasons why it matters whether a distribution is a “dividend” or something else. Let’s begin by looking at what difference it makes to shareholders who receive distributions. You’ll recall (from the Survey course) that dividends are taxable income to shareholders who receive them. Here again is the Code section that makes this so:

§ 61. Gross income defined

- (a) General definition. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . .
 - (7) Dividends. . .

Section 61(a) seems perfectly clear. But, apparently in an effort to be certain that no one misunderstands or forgets, Congress included an additional section in the Code that says so again, in different words:

§ 301. Distributions of property

- (a) In general. Except as otherwise provided in this chapter, a distribution of property . . . made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).
 - . . .
 - (c) Amount taxable. In the case of a distribution to which subsection (a) applies -
 - (1) Amount constituting dividend. That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

You’ll recall that until the end of the year 2010, distributions that are “dividends” are taxed at capital gains rates, not at higher ordinary income rates. Here’s the section that makes that so:

§ 1. Tax imposed

- . . .
 - (h) Maximum capital gains rate
 - . . .
 - (11) Dividends taxed as net capital gain. —
 - (A) In general.— For purposes of this subsection, the term “net capital gain” means net capital gain (determined without regard to this paragraph) increased by qualified dividend income.
 - (B) Qualified dividend income. — for purposes of this paragraph—
 - (i) In general. — The term “qualified dividend income” means dividends received during the taxable year from . . . corporations. . . .

Notice two things about § 1(h)(11). First, it limits "capital gain" treatment to "qualified" dividends. But, second, it defines "qualified" dividends as those paid by corporations. In other words, the word "qualified" is virtually insignificant. It's in the Code merely because some types of investments – like money market funds and fixed income mutual funds – make payments that are *called* "dividends" but really aren't; they're really interest, and as such are taxed at ordinary rates.

So now we can see why, this year, it may be better (less expensive, tax-wise) for shareholders to receive distributions that are "dividends" than to receive distributions that are something else. On the other hand, you'll see (below) that if dividends become taxable once again as ordinary income in 2011, it may be better for shareholders to receive distributions that aren't dividends. And, as you'll see (below), even this year, it may be better for shareholders to receive distributions that are *not* dividends!

This means that it's important to be clear about the requirement that distributions be out of "earnings and profits" in order to be "dividends," and what happens if a distribution is not out of "earnings and profits" and thus isn't a "dividend."

What are "earnings and profits"?

Given how important "earnings and profits" are (in determining whether distributions are "dividends"), you would suppose that the Code contains a specific definition of "earnings and profits." But, surprisingly, it doesn't.

"Earnings and profits" are similar to – but not identical with – "taxable income." Rather than define "earnings and profits," the Code requires that several specified adjustments be made to a corporation's taxable income, in order to arrive at its "earnings and profits." These adjustments are scattered about in several subparagraphs of § 312 (though strangely, those subparagraphs never refer to "taxable income" by name). To give you a sense of the sorts of adjustments that are required, here's one: if in calculating its taxable income, a corporation took a §179 deduction for the full cost of depreciable property in the year it purchased that property, the corporation's "earnings and profits" will be different than (actually, greater than) its "taxable income," because, for the purpose of calculating "earnings and profits" (but only for that purpose), §312 will require the corporation to deduct the cost of that equipment in equal installments over five years (rather than in one).

For our purposes, in this class, we'll disregard the distinction between "taxable income" and "earnings and profits." In doing so, we'll lose a bit of authenticity, but we'll avoid the need to do a lot of simple but time-consuming arithmetic. We're more interested in what happens if a corporation makes a distribution that is not a dividend (because the distribution is not out of earnings and profits) than what the difference is between "taxable income" and "earnings and profits."

One last point, before we get to the consequences of making distributions that are not out of earnings and profits: the version of § 316(a) quoted above – the section that defines "dividends" – was heavily edited. In full text, that section makes a distinction between:

- 1) a corporation's earnings and profits accumulated (because they were not distributed) in the years *before* the distribution was made, and
- 2) a corporation's earnings and profits *during* the year in which the distribution was made.

The first of these (#1 just above) are called "accumulated" earnings and profits; and the second are called "current" earnings and profits. The difference between them *could* matter. It would, if a corporation distributed more than its current earnings and profits, but had

enough accumulated earnings and profits to cover the balance. The Schwarz & Lathrope book describes how this would be handled (at pages 177-178). The Example in the book, as well as in the Regulation it cites, involves mid-year distributions, where the timing of the distributions is the source of the complication. In order to see what the complication is, it's necessary to do some arithmetic. The book does it. The arithmetic isn't hard. But it isn't necessary for our purposes.

For our purposes, it's sufficient to know that

- distributions are deemed to have been made first from current earnings and profits, and then, if necessary, from accumulated earnings and profits, and
- distributions from current earnings and profits are always "dividends," and distributions from accumulated earnings and profits also are dividends, most of the time.

What if distributions are *not* from earnings and profits?

If a distribution is not from earnings and profits, it's not a dividend. Corporations don't get to choose whether or not to make distributions from earnings and profits. If a corporation has earnings and profits, any distributions it makes will be from those earnings and profits. Sometimes, though, corporations distribute more than they have in earnings and profits; and when they do, those distributions are not from earnings and profits. Again, if the distribution is not from earnings and profits, it's not a "dividend."

So now we need to know what the tax consequences are, when a non-dividend distribution is made. The answer is really quite simple. A non-dividend distribution to a shareholder

- reduces the shareholder's basis in his or her stock; and if the distribution is greater than that basis (i.e., if the basis is reduced to \$0) . . .
- the excess (the amount by which the distribution exceeds the shareholder's stock basis) is treated as a gain from the sale of that stock.

Here is the Code section that makes this so:

§ 301. Distributions of property

(a) In general. Except as otherwise provided in this chapter, a distribution of property [including money] . . . made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

. . .

(c) Amount taxable. In the case of a distribution to which subsection (a) applies - . . .

(2) Amount applied against basis. That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock [owned by the shareholder who received the distribution].

(3) Amount in excess of basis

(A) In general. . . that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock [owned by the shareholder who received the distribution], shall be treated as gain from the sale or exchange of property. . .

If property (rather than money) is distributed, what is the amount of the dividend or other distribution?

If a corporation distributes money (as a dividend or otherwise), the amount is perfectly obvious. Suppose, though, that the corporation distributes property to a shareholder. Shareholders must be clear about the amount they received, in order to report the amount as a dividend (if it the distribution was a dividend) or in order to calculate the reduction in their stock basis and maybe the amount of their "gain" (if the distribution was not a dividend). Here is the Code section that tells us the amount of the distribution, if the corporation distributes property. It also tells us what the shareholder's basis is, in property received from the corporation, and how the amount of the distribution is affected if liabilities are distributed to shareholders (along with money or property).

§ 301. Distributions of property

...

(b) Amount distributed

- (1) General rule. For purposes of this section, the amount of any distribution shall be the amount of money received [by the shareholder], plus the fair market value of the other property received [by the shareholder].
- (2) Reduction for liabilities. The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by –
 - (A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and
 - (B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.
- (3) Determination of fair market value. For purposes of this section, fair market value shall be determined as of the date of the distribution.

...

(d) Basis. The basis of property received in a distribution to which subsection (a) applies shall be the fair market value of such property.

You now know pretty much everything you need to, in order to figure the tax consequences of corporate distributions to *shareholders*. (Questions below will let you see whether you do.) Next we'll look at the consequences to the distributing *corporation*.

Tax consequences to corporations of dividends or other distributions

Although dividends are income to shareholders who receive them, dividends are not deductible by corporations that pay them. There isn't a Code section that states this; but that's because nothing is deductible unless a Code section authorizes a deduction (§ 63(a)), and no Code section authorizes corporations to deduct dividends they pay to shareholders.

Because dividends are not deductible by the corporation, but are income to shareholders, some closely-held corporations and their shareholders may be tempted to make payments to shareholders that are not dividends (or other distributions). It's an easy thing to do, if the shareholders are: employees, because they can be paid salaries; landlords, because they can be paid rent; or lenders, because they can be paid interest. Salaries, rent and interest all are deductible expenses to the corporation. But if these sorts of payments are

greater than they would be to non-shareholders, the IRS may recharacterize a portion of these payments as "constructive dividends," and thereby deprive the corporation of the deductions.

Back when dividends were taxed at the same rate as salaries, rent and interest, closely-held corporations had a tremendous incentive to pay shareholders more in salary, rent and interest than they would pay non-shareholders, because doing that would save the corporation taxes without increasing the taxes of shareholders. Now, and through 2010, the calculation is more complicated, because dividends are taxed at lower capital gains rates than salaries, rents and interest, all of which are taxed at higher ordinary income rates. The "constructive dividend" issue will resume its former importance in tax law, if dividends are once again taxed at ordinary rates, after 2010.

Even though dividends and other distributions are not deductible by corporations, there are some tax *consequences* to corporations that distribute money or property to shareholders (as dividends or otherwise).

One consequence is that *if* the corporation distributes *property* (rather than, or in addition to, money), the corporation may have to recognize income. Here is the Code section that indicates the circumstances under which a corporation will have to recognize income. (The Code section contains the phrase "distribution . . . with respect to its stock." That simply means a distribution to shareholders *because they are shareholders* – not salaries, rents and interest payments made to shareholders who also are the corporation's employees, landlords and lenders.)

§ 311. Taxability of corporation on distribution

- (a) General rule. Except as provided in subsection (b), no gain or loss shall be recognized to a corporation on the distribution (not in complete liquidation) with respect to its stock of . . . property.
- (b) Distributions of appreciated property
 - (1) In general. If -
 - (A) a corporation distributes property . . . to a shareholder . . ., and
 - (B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

Another consequence is that distributions decrease, or in some cases increase, the amount of the corporation's "earnings and profits." Remember that "earnings and profits" are *not* "taxable income," so even an increase in "earnings and profits" does not result in the recognition of income. But, since distributions are "dividends" only if they come out of earnings and profits, increases or decreases in earnings and profits are significant for the purpose of determining whether subsequent distributions are or are not "dividends." Here is the Code section that indicates that distributions decrease or increase earnings and profits. (You'll find the phrase "distribution . . . with respect to its stock" this section too, and it means the same thing it means in § 311(a) above.)

§ 312. Effect on earnings and profits

- (a) General rule. Except as otherwise provided in this section, on the distribution of property [including money] by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of -
 - (1) the amount of money,
 - (2) the principal amount of the obligations of such corporation . . . , and
 - (3) the adjusted basis of the other property, so distributed.
- (b) Distributions of appreciated property. On the distribution by a corporation, with respect to its stock, of any property (other than an obligation of such corporation) the fair market value of which exceeds the adjusted basis thereof -
 - (1) the earnings and profits of the corporation shall be increased by the amount of such excess, and
 - (2) subsection (a)(3) shall be applied by substituting "fair market value" for "adjusted basis".

. . .
- (c) Adjustments for liabilities. In making the adjustments to the earnings and profits of a corporation under subsection (a) or (b), proper adjustment shall be made for -
 - (1) the amount of any liability to which the property distributed is subject, and
 - (2) the amount of any liability of the corporation assumed by a shareholder in connection with the distribution.

Schwarz & Lathrope

Pages 171-183

Pages 171-183 cover the same points made above in this Study Guide, in a somewhat different order and in greater detail. If you're uncertain about something, or you find these issues particularly interesting, give Schwarz & Lathrope a read. However, the following questions (and those on the test) will not require you to have read those pages.

Questions re Taxing Dividends and Other Distributions

1. The corporation formed by Anne, Beth, Carl and Doug had an excellent first year. It had earnings and profits of \$100,000, and it distributed \$25,000 in cash to each of them. Anne's basis in her stock is \$100,000; Beth's basis is \$50,000; Carl's is \$25,000; and Doug's is \$100,000. Which of the following best describes those distributions?
 - a. The distribution to Anne is interest. The distribution to Beth and Carl is rent. And the distribution to Doug is salary. The entire \$100,000 is deductible by the corporation (in calculating its taxable income). The distributions are taxable to Anne, Beth, Carl and Doug at ordinary income rates.
 - b. All of the distributions are dividends, taxable to Anne, Beth, Carl and Doug at capital gains rates. The distributions are not deductible by the corporation, however.
 - c. All of the distributions are dividends, taxable to Anne, Beth, Carl and Doug at ordinary income rates. Because the four of them will pay tax on their dividends, the distributions are deductible by the corporation.

2. The corporation formed by Anne, Beth, Carl and Doug had an excellent first year. It had earnings and profits of \$100,000, and it distributed \$30,000 in cash to each of them. Anne's basis in her stock is \$100,000; Beth's basis is \$50,000; Carl's is \$25,000; and Doug's is \$100,000. Which of the following best describes those distributions?
- All of the distributions are dividends, taxable to Anne, Beth, Carl and Doug at capital gains rates. The distributions are not deductible by the corporation, however.
 - All of the distributions are dividends, taxable to Anne, Beth, Carl and Doug at ordinary income rates. Because the four of them will pay tax on their dividends, the distributions are deductible by the corporation.
 - \$25,000 of each distribution is a dividend, taxable to Anne, Beth, Carl and Doug at capital gains rates. \$5,000 of each distribution is not a dividend; it is taxable to Anne, Beth, Carl and Doug at ordinary income rates. Because the four of them will pay tax on \$5,000 each, the corporation will be able to deduct \$20,000.
 - \$25,000 of each distribution is a dividend, taxable to Anne, Beth, Carl and Doug at capital gains rates. \$5,000 of each distribution is not a dividend; it isn't taxable to Anne, Beth, Carl or Doug, at all. However, each of their bases in their stock will be reduced by \$5,000: Anne's and Doug's to \$95,000 each; Beth's to \$45,000; and Carl's to \$20,000.
3. The corporation's second year wasn't quite as good. It's earnings and profits for its second year were \$0, but it distributed \$30,000 in cash each to Anne, Beth, Carl and Doug, anyway. If the answer to Question 2 was "d," so that Carl's basis in his stock was \$20,000 at the end of the first year, what were the tax consequences to Carl of the \$30,000 distribution at the end of the second year?
- The entire \$30,000 was a dividend, taxable to him at capital gains rates.
 - The entire \$30,000 was a non-dividend distribution, taxable to him at ordinary income rates.
 - The entire \$30,000 was a non-dividend distribution. \$10,000 will be taxed to him at capital gains rates. The other \$20,000 is not taxable to him; but it did reduce his basis in his stock to \$0, so when he sells the stock, the entire amount that he receives will be "gain" to him, taxable at capital gains rates.

4. Immediately after the corporation was formed, it used some of the cash contributed by Anne to purchase four computers for \$1,500 each. The corporation wrote off the entire cost of those computers in the year they were purchased, as permitted by Code § 179; though in computing its first year "earnings and profits," the corporation wrote off only \$300 per computer, as required by § 312. Unfortunately, the corporation soon discovered that the computers were not powerful enough to perform the tasks for which they were purchased. As a result, the corporation distributed the computers – one to each partner – and purchased new computers that are powerful enough to do the job. By the time the partnership distributed the computers, they were "used" computers (though they were in perfect condition), and thus their fair market value was only \$500 each. Despite having to buy two sets of computers, the corporation's first year "earnings and profits" were \$100,000. The corporation didn't distribute anything else to the shareholders that year. What were the tax consequences to the shareholders as a result of the corporation's distribution of the computers?
- Each shareholder received a \$500 dividend, that being the fair market value of each computer at the time it was distributed; so each had \$500 in income that was taxable at capital gains rates.
 - Each shareholder received a \$1,200 dividend, because that was the corporation's "earnings and profits" basis in each computer, when they were distributed; so each shareholder had \$1,200 in income that was taxable at capital gains rates.
 - Each shareholder received a \$0 dividend, because that was the corporation's tax basis in each computer, when they were distributed; so none of them had taxable income from the distribution.
5. Anne didn't need or want the computer that was distributed to her; but Doug wanted a second computer in addition to the one that was distributed to him. As a result, Doug paid Anne \$500 for her computer, and both were happy. How much income, if any, did Anne have to recognize as a result of this transaction?
- \$500, because that's the difference between the amount Doug paid and Anne's basis in the computer.
 - Nothing, because Doug paid just the fair market value of the computer at the time he bought it.
 - Nothing, because that's the difference between the amount Doug paid and Anne's basis in the computer.
 - She had a \$700 loss, because that's the difference between the amount Doug paid and Anne's basis in the computer.
6. What were the tax consequences to the corporation as a result of its distribution of the computers?
- The corporation had taxable income of \$500 per computer – \$2,000 in all – because that is the difference between the fair market value of the computers and the corporation's basis in the computers, at the time they were distributed.
 - There were no tax consequences to the corporation.
 - The corporation had a deductible loss of \$1,000 per computer – \$4,000 in all – because that is the difference between what it paid for the computers when it bought them, and their fair market value when it distributed them.

7. What effect, if any, did the corporation's distribution of the computers have on its earnings and profits?
- It had no *net* effect, because the distribution of computers having a total fair market value of \$2,000 (\$500/computer) decreased the corporation's earnings and profits by \$2,000 (under § 312(a)(3) and (b)(2)) and also increased the corporation's earnings and profits (under § 312(b)(1)) by \$2,000.
 - It had a *net* effect of increasing the corporation's earnings and profits by \$2,000, because the distribution of computers having a total fair market value of \$2,000 (\$500/computer) decreased the corporation's earnings and profits by \$0 (under § 179 and § 312(a)(3)) and also increased the corporation's earnings and profits (under § 312(b)(1)) by \$2,000.
 - It had a *net* effect of decreasing the corporation's earnings and profits by \$2,000, because the distribution of computers having a total fair market value of \$2,000 (\$500/computer) decreased the corporation's earnings and profits by \$2,000 (under § 312(a)(3)) and also increased the corporation's earnings and profits (under § 312(b)(1)) by \$0.

Taxing Fringe Benefits

You'll recall (from the Survey course, and Study Guide 11 at page 9) that several fringe benefits are not taxable income to employees while still being tax deductible to employers. The principle got a bit complicated for partnerships, because partners are not employees. As a result, fringe benefits provided by partnerships to their partners (though deductible by partnerships) are income to partners, *unless* the Code treats partners as employees (as the Code does for some but not all fringe benefits), or the Code allows partners to fully deduct the cost of a fringe benefit, something the Code does permit with respect to health insurance premiums (by virtue of an artificial definition of the term "self-employed").

For corporations and their shareholders, the tax treatment of fringe benefits is very much simpler. It is, because a corporation and its shareholders are entirely separate and distinct tax-paying entities. So shareholders who are *employed* by their corporation really wear two tax "hats": they are shareholders; and they are true employees.

This means that corporations may provide tax-free fringe benefits to their employees, including shareholders who are employees. The only caveat here is that fringe benefits may be provided only to shareholders who also really are employees. Benefits provided to shareholders who are not employed by the corporation would be dividends or other distributions.

Paying Payroll Taxes

The payroll tax issue is easier for corporations than partnerships too. The corporation is the employer, and must pay the employer's share of Social Security and Medicare taxes for employees who are shareholders (as well as for employees who are not, of course).

Shareholders who are not employees do not receive wages. They receive dividends or other distributions; and Social Security and Medicare taxes are not assessed on dividends or other distributions. (This is yet another reason why it is now complicated to calculate whether it is less expensive, tax-wise, for shareholder/employees to be compensated with salaries or dividends.)

Study Guide 14

OPERATING A BUSINESS

Operating a C Corporation

Preventing Tax Avoidance

Preventing Tax Avoidance

When I put together the syllabus for this course, I included the chapter in the Schwarz & Lathrope book titled "Anti-Avoidance Provisions" (pages 276-290). The chapter contains excellent discussions of three corporate tax doctrines:

- The "Accumulated Earnings Tax"
- The "Personal Holding Company Tax" and
- Collapsible Corporations.

These doctrines were very important when I was a law student, and for years afterwards. At the syllabus-designing stage of this course, I could hardly imagine a business tax class that didn't devote some time to these topics; so I included them. As it happens, none of the three is important any more, though the Code sections and Regulations that make up these doctrines are still on the books. They remain on the books, apparently, because they could become important once again, if significant changes are enacted in the rates of tax that corporations and shareholders pay.

However, in order for these doctrines to become important again, rates would have to change far more dramatically than they will as a result of the expiration of the "Bush tax cuts" at the end of 2010. Some people thought that President Obama would seek legislation that ended the Bush tax cuts before the end of 2010; but he hasn't, and he hasn't talked about doing so, since being elected. Moreover, he hasn't talked about raising tax rates above where they were before the Bush tax cuts took effect. So for the foreseeable future, the Accumulated Earnings Tax, Personal Holding Company Tax, and Collapsible Corporation doctrine are unlikely to be of professional concern to you.

What I would like you to understand – as tax-paying citizens yourselves, as well as lawyers – is

- why these three doctrines became necessary in the first place,
- why they aren't important now, and
- what would have to happen to tax law in order for them to become important again.

You can distill these three points for yourselves by reading the Schwarz & Lathrope chapter (pages 276-290). But I'm going to do it in class too, by lecture. And I'm not going to ask any questions about these doctrines (in class or on the exam).

Study Guide 15

OPERATING A BUSINESS

Operating a Subchapter S Corporation

Electing to be a Subchapter S Corporation

Determining Taxable Income

Operating a Subchapter S Corporation

As a matter of *state* law, a corporation is a corporation . . . is a corporation (just the way “a rose is a rose”). State law, in other words, doesn’t distinguish between “C corporations” and “S corporations.” The difference between “C” and “S” corporations is a matter of federal tax law. At birth (i.e., when a corporation is first formed by filing Articles of Incorporation with the California Secretary of State, or corresponding officials of other states), all corporations are alike, and all are “C corporations.” If a C corporation has the right characteristics, and its shareholders want it to be an S corporation, they may elect to turn their corporation into an S corporation; and later, if they want to turn it back into a C corporation again, they may do that too.

The question is why shareholders might want to elect to turn their corporation into an S corporation; and the answer is simple: sometimes, for reasons related to *state* law, business owners would prefer a corporation, but for reasons related to *tax* law, they would prefer a partnership.

Recall that the reading assignment for Study Guide 12 included a section titled “Disregard of the Corporate Entity,” which described the circumstances under which a corporation might be taxed as a partnership, at the behest of the shareholders. The cases cited in that section of the book were decided back in the 1940s (Schwarz & Lathrope, at page 115). A decade or so later, Congress gave business owners what they wanted: a simple and sure method by which they could form a corporation, and get all of the benefits of corporate form for *state* law purposes, while at the same time getting the benefits of partnership form, for *tax* purposes. Congress did so by enacted “Subchapter S” of the Internal Revenue Code, to which we will now turn our attention.

Electing to be a Subchapter S Corporation

Eligibility to Elect to be a Subchapter S Corporation

Not all corporations are eligible to be S corporations. Publicly-traded corporations – like Microsoft and Disney – are not, because they have too many shareholders. On the other hand, some pretty big companies, measured by number of employees and sales volume, are. Robinson Helicopter Company, for example, is an S corporation, despite having 1200 employees, sales of more than \$250 million a year, and dealers and service centers in more than 55 countries including Russia and China.

Here is the Code section that describes the characteristics a corporation must have to be eligible to be an S corporation:

§ 1361. S corporation defined

- (a) S corporation defined
- (1) In general. For purposes of this title, the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.
- ...
- (b) Small business corporation
- (1) In general. For purposes of this subchapter, the term "small business corporation" means a domestic corporation . . . which does not -
- (A) have more than 100 shareholders,
- (B) have as a shareholder a person . . . who is not an individual,
- (C) have a nonresident alien as a shareholder, and
- (D) have more than 1 class of stock.
- ...
- (c) Special rules for applying subsection (b)
- (1) Members of a family treated as 1 shareholder.—
- (A) In general.—For purposes of subsection (b)(1)(A), there shall be treated as one shareholder—
- (i) a husband and wife (and their estates), and
- (ii) all members of a family (and their estates).
- ...
- (4) Differences in common stock voting rights disregarded. For purposes of subsection (b)(1)(D), a corporation shall not be treated as having more than 1 class of stock solely because there are differences in voting rights among the shares of common stock.
- (5) Straight debt safe harbor
- (A) In general. For purposes of subsection (b)(1)(D), straight debt shall not be treated as a second class of stock.
- (B) Straight debt defined. For purposes of this paragraph, the term "straight debt" means any written unconditional promise to pay on demand or on a specified date a sum certain in money if -
- (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors,
- (ii) there is no convertibility (directly or indirectly) into stock. . . .

Read (in Schwarz & Lathrope)

Pages 399-405

This reading assignment describes the nuances of Code § 1361. But notice that most of those nuances deal with just two subjects:

- circumstances under which a corporation might qualify to be an S corporation, even though more than 100 people properly think of themselves as being shareholders, and
- circumstances under which a corporation with as few as two shareholders may not be eligible to be an S corporation.

The corporation formed by Anne, Beth, Carl and Doug is easily within the 100 shareholder limit. (And so were all of the corporations that I ever formed for clients, when I was in private law practice.) Consider, though, the following scenarios, which are pretty realistic.

Questions re Eligibility

1. Anne, Beth, Carl and Doug agree that each should own 25% of the stock in their corporation. But they also acknowledge that Anne is the only one of them who put any cash into the business. Suppose that for this reason, the four of them agree that Anne will receive preferred stock and the others will receive common stock; and that the preferred stock will entitle Anne to receive \$2 in distributions for every \$1 in distributions the others receive, until Anne has received a total of \$100,000 in distributions, at which time her preferred stock will entitle her the same distributions as the others. Under these circumstances, would the corporation be eligible to be an S corporation? Why or why not?
 - a. Yes, because the corporation still has fewer than 100 shareholders.
 - b. No, because the corporation has more than one class of stock.
2. Suppose that all four shareholders receive common stock, each share of which entitles the holder to the same distributions as the others, but Anne's common stock entitles her to 4 votes per share, Beth's to 3 votes per share, Carl's to 2 votes per share, and Doug's to 1 vote per share, until such time as Anne has received \$100,000 in distributions, Beth has received \$50,000 in distributions, and Carl has received \$25,000 in distributions, at which time the shares owned by all four of them will entitle the holder to just 1 vote per share. Under these circumstances, would the corporation be eligible to be an S corporation? Why or why not?
 - a. Yes, because the corporation still has fewer than 100 shareholders and only one class of stock.
 - b. No, because even though the corporation appears to have only one class stock because all of the stock is common stock, in fact, the corporation has four classes of stock because each shareholder's stock has different voting rights from each other shareholder's stock.
3. Suppose that Anne is a Canadian national who lives in Vancouver, British Columbia. Under these circumstances, would the corporation be eligible to be an S corporation? Why or why not?
 - a. Yes, because foreigners are allowed to own stock in American corporations.
 - b. No, because that would mean that one of the shareholder's is a nonresident alien.
4. Suppose that Anne is a U.S. citizen, but instead of receiving stock for her entire \$100,000 investment, she invested \$50,000 for stock and loaned the corporation \$50,000. The corporation's promissory note requires it to repay Anne's loan in monthly installments with interest at then-prevailing rates if the corporation has sufficient cash on hand to do so; and if the corporation misses two consecutive payments, Anne has the option to convert her note into additional common stock. Under these circumstances, would the corporation be eligible to be an S corporation? Why or why not?
 - a. Yes, because the corporation still has fewer than 100 shareholders and only one class of stock.
 - b. No, because the interest payment dates are contingent on a factor similar to profits (i.e., cash on hand), and/or the note is convertible into stock.

Making the Election

If a corporation is eligible to elect to be an S corporation, doing so is not difficult. Here is the Code section that explains what must be done and when it must be done.

§ 1362. Election; revocation; termination

(a) Election

- (1) In general. . . . a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation.
- (2) All shareholders must consent to election. An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

(b) When made

- (1) In general. An election under subsection (a) may be made by a small business corporation for any taxable year -
 - (A) at any time during the preceding taxable year, or
 - (B) at any time during the taxable year and on or before the 15th day of the 3d month of the taxable year.

The election itself is made by having shareholders indicate their required consent by signing Form 2553 (a copy of which is at the end of these Study Guides).

Read (in Schwarz & Lathrope)

Pages 405-409

Questions re Making the Election

5. Suppose Beth, Carl and Doug want the corporation to be an S corporation, but Anne does not. If the four of them own the same number of shares each, and each share is entitled to one vote, may Beth, Carl and Doug out-vote Anne, 75% to 25%, to make the corporation an S corporation?
 - a. No, the decision must be unanimous.
 - b. Yes, a simple majority vote is all that is needed, so 75% exceeds the required vote by a substantial margin.
6. If Anne, Beth, Carl and Doug formed their corporation in January of this year, and if the corporation selected a tax year ending December 31st (more on that below), by what date do they have to make a Subchapter S election, if they wish their corporation to be an S corporation right from the start of its life?
 - a. They have until March 15th of next year.
 - b. They have until December 31st of this year.
 - c. They have until March 15th of this year.
 - d. They should have made it immediately after forming the corporation, back in January.

Determining Taxable Income

Determining the taxable income of an S corporation (indeed, of any person or entity) requires an understanding of gross income and deductions and two other things as well:

- what accounting method the taxpayer uses – “cash,” or “accrual,” and
- what “tax year” the taxpayer uses – the calendar year (January through December) or some other year-long period.

Accounting Method and Tax Year

The Schwarz & Lathrope book begins with accounting method and tax year, so we will too. As you’ll see, the book doesn’t say much about which accounting method an S corporation must use, because as a general rule, an S corporation may choose whichever method it prefers.

There’s more to be said about an S corporation’s tax year. There is, because even though corporations generally may choose whatever tax year they like, when it comes to S corporations, there would be an enormous incentive to choose a February through January tax year, because that would enable shareholders to delay paying taxes on their S corporation income for almost a year and a quarter. (The book explains how.) To prevent that from happening, the Code contains provisions that make it tough to do.

§ 1378. Taxable year of S corporation

- (a) General rule. For purposes of this subtitle, the taxable year of an S corporation shall be a permitted year.
- (b) Permitted year defined. For purposes of this section, the term “permitted year” means a taxable year which -
 - (1) is a year ending December 31, or
 - (2) is any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Secretary.For purposes of paragraph (2), any deferral of income to shareholders shall not be treated as a business purpose.

§ 444. Election of taxable year other than required taxable year

- (a) General rule. Except as otherwise provided in this section, a[n] . . . S corporation . . . may elect to have a taxable year other than the required taxable year.
- (b) Limitations on taxable years which may be elected
 - (1) In general. . . . an election may be made under subsection (a) only if the deferral period of the taxable year elected is not longer than 3 months.
 -
 - (4) Deferral period. For purposes of this subsection, except as provided in regulations, the term "deferral period" means, with respect to any taxable year of the entity, the months between -
 - (A) the beginning of such year, and
 - (B) the close of the 1st required taxable year ending within such year.
- (c) Effect of election. If an entity makes an election under subsection (a), then -
 - (1) in the case of a[n] S corporation, such entity shall make the payments required by section 7519. . . .
 -
- (e) Required taxable year. For purposes of this section, the term "required taxable year" means the taxable year determined under section . . . 1378 . . . without taking into account any taxable year which is allowable by reason of business purposes. . . .

Read (in Schwarz & Lathrope)

Pages 409-412

Shareholders of an S corporation let the IRS know what tax year they've chosen on the same Form 2553 they use to make the S corporation election in the first place.

Calculating Income and Other Items

The calculation of an S corporation's income is so similar to the calculation of a partnership's income that the corresponding S corporation Code sections are structured like the Code sections we studied when we looked at partnership taxation, and actually incorporate some of those sections by reference.

§ 1363. Effect of election on corporation

- (a) General rule. Except as otherwise provided in this subchapter, an S corporation shall not be subject to the taxes imposed by this chapter.
- (b) Computation of corporation's taxable income. The taxable income of an S corporation shall be computed in the same manner as in the case of an individual, except that -
 - (1) the items described in section 1366(a)(1)(A) shall be separately stated,
 - (2) the deductions referred to in section 703(a)(2) shall not be allowed to the corporation. . . .
- (c) Elections of the S corporation
 - (1) In general. . . . any election affecting the computation of items derived from an S corporation shall be made by the corporation.

§ 1366. Pass-thru of items to shareholders

(a) Determination of shareholder's tax liability

(1) In general. In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends . . . , there shall be taken into account the shareholder's pro rata share of the corporation's -

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder

For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

§ 703. Partnership computations

(a) Income and deductions. The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that -

. . . .
(2) the following deductions shall not be allowed to the partnership: [personal exemptions; deduction for taxes paid to foreign countries; deduction for charitable contributions; itemized deductions for individuals; and a couple of others].

§ 702. Income and credits of partner

(a) General rule. In determining his income tax, each partner shall take into account separately his distributive share of the partnership's -

. . . .
(4) charitable contributions . . . ,
. . . .
(6) taxes . . . paid . . . to foreign countries. . . .

Read (in Schwarz & Lathrope)

Pages 412-413

Also, look at Form 1120S (a copy of which is at the end of these Study Guides).

Questions re Calculating Income and Other Items

7. Anne, Beth, Carl and Doug expect their business to lose a little money the first year, and hope it will become profitable the second. The business will have income from very ordinary sources (the sale of manufactured goods or goods purchased at wholesale; or something like that) and it will have only a handful of categories of expenses, also very ordinary. If allowed to do so, the business could easily keep track of its income and expenses using an off-the-shelf computer program (like Quicken), running on a \$400 computer. For the first couple of years, Anne, Beth, Carl and Doug would like to keep things as simple as possible. If they form a S corporation, what is the simplest form of tax reporting and payment they will be allowed to use?
 - a. They can simply divide the S corporation's income and expenses into quarters, and each of them can report his or her quarter on a Schedule C attached to their personal income tax returns, and not have the S corporation itself report or pay anything.
 - b. The S corporation can report all of its income and expenses on a tax return filed in the S corporation's name, and pay any tax that may be due, and not have Anne, Beth, Carl and Doug report or pay anything.
 - c. If the S corporation loses money, option "b" can be used; but if the S corporation makes money, option "a" will have to be used.
 - d. The S corporation will have to report all of its income and expenses on a tax return filed in the S corporation's name, but the S corporation will not pay taxes itself, even if the S corporation is profitable. In addition, Anne, Beth, Carl and Doug each will have to report their shares of the S corporation's profits or losses on their own personal tax returns; and if the S corporation made a profit, each of them will have to pay tax on his or her own share of that profit.

8. How will the S corporation calculate whether it made a profit or suffered a loss?
 - a. Using precisely the same rules that Anne, Beth, Carl and Doug would have used, if one of them had run the business as a sole proprietorship (rather than as an S corporation) – i.e., all of the rules that were covered in the Survey of Federal Income Tax course.
 - b. Using most of the same rules that Anne, Beth, Carl and Doug would have used, if one of them had run the business as a sole proprietorship (rather than as an S corporation) – i.e., most of the rules that were covered in the Survey of Federal Income Tax course.
 - c. Using an entirely separate and different set of rules than the rules that Anne, Beth, Carl and Doug would have used, if one of them had run the business as a sole proprietorship (rather than as an S corporation) – i.e., none of the rules that were covered in the Survey of Federal Income Tax course would be used.

9. Which, if any, of the following types of expenses will the S corporation be able to deduct, assuming of course the S corporation actually incurs such expenses? (Circle all that apply.)

- I. personal exemptions for each of the shareholders
 - II. charitable contributions made by the S corporation
 - III. rent
 - IV. utilities
 - V. advertising
 - VI. accounting and legal fees (for operations, not start-up)
 - VII. all of the above
 - VIII. none of the above
- a. I and II.
 - b. III, IV, V and VI.
 - c. VII.
 - d. VIII.

Study Guide 16

OPERATING A BUSINESS

Operating a Subchapter S Corporation

- Taxing S Corporation Shareholders
 - Dealing with Items Not Covered in Subchapter S
 - Taxing Fringe Benefits
 - Paying Payroll Taxes
-

Taxing S Corporation Shareholders

Read (in Schwarz & Lathrope)

Pages 413-421 and 429-430

There are tax consequences to being a shareholder in an S corporation, simply by being a shareholder and doing nothing more. There are additional and quite separate consequences if an S corporation shareholder also is an employee of the corporation. We'll begin by looking at the consequences of simply being an S corporation shareholder; and we'll leave to the end of this Study Guide the consequences of being an employee.

Timing and Character of Pass Through Items

The key tax feature of an S corporation is that its income and other tax items are "passed through" to its shareholders who report them on their own personal tax returns. Here is the Code section that makes this so:

§ 1366. Pass-thru of items to shareholders

- (a) Determination of shareholder's tax liability
 - (1) In general. In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends . . . , there shall be taken into account the shareholder's pro rata share of the corporation's -
 - (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
 - (B) nonseparately computed income or loss.For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).
 - (2) Nonseparately computed income or loss defined. For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).
- (b) Character passed thru. The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

§ 702. Income and credits of partner

(a) General rule. In determining his income tax, each partner shall take into account separately his distributive share of the partnership's -

...

(4) charitable contributions . . . ,

...

(6) taxes . . . paid . . . to foreign countries. . . .

Questions re Pass Through to Shareholders

1. During its first year of operation, the S corporation did the following:

- The S corporation didn't immediately need all of the \$100,000 contributed by Anne; but instead of depositing the money in a bank account that didn't pay interest, the S corporation purchased short-term corporate notes that did pay interest. As the S corporation needed cash, it sold the notes, and made a \$10,000 profit doing so!
- The S corporation discovered that some of the equipment that Carl contributed was not suitable for its business, so it sold the unsuitable equipment, and made another \$10,000 profit doing so.
- The S corporation contributed \$1,000 to a local charity.
- The S corporation lost \$19,000 on its day-to-day operations (i.e., its expenses – not including any of the three items above – exceeded its total income by \$19,000).

How will these matters be reported by Anne, Beth, Carl and Doug?

- a. The S corporation tax return will show that it had ordinary business income of \$0 (\$20,000 in profit from the sale of the notes and equipment, less \$1,000 charitable contribution, less \$19,000 lost on operations); and each shareholder will report \$0 income on his or her personal tax return.
- b. The S corporation return will show that it had an ordinary business loss of \$19,000; and each shareholder will *report* a loss of \$4,750 on his or her personal tax return (though whether it will be *deductible* by all shareholders is a separate question). Also, each shareholder will report and deduct a charitable contribution of \$250 (25% of the \$1,000 contributed by the S corporation) on his or her personal income tax return. And each shareholder will report and include in gross income his or her \$2,500 share of the \$10,000 gain from the sale of the notes, and his or her \$2,500 share of the \$10,000 gain from the sale of the equipment.

2. When Anne, Beth, Carl and Doug report their shares of the S corporation's gain from the sale of the equipment, will they report a *short-term* or a *long-term* capital gain on the portion of the gain attributable to the S corporation's sale of the equipment for more than Doug originally paid for it? (Recall that Doug bought the equipment more than a year before the S corporation sold it, and that the corporation's holding period is the same as Doug's. (Study Guide 3, pages 8-9))
- a. It will be a short-term capital gain as to Anne, Beth and Carl, because they were shareholders in the S corporation for less than a year when the S corporation sold the equipment. But it will be a long-term capital gain as to Doug, because he owned the equipment for more than a year, first personally, and then through the S corporation.
 - b. It will be a long-term capital gain as to all four of them, because the S corporation's holding period in the equipment was the same as Doug's; and the short or long-term character of the equipment as reported by all four is the same as it was in the hands of the S corporation.

Determining Each Shareholder's Pro Rata Share

Although the earnings and other tax items of an S corporation that are allocated among its shareholders are similar to the earnings and other tax items of a partnership that are allocated among its partners, the rules for making allocations among S corporation shareholders are more rigid, and thus simpler. In an S corporation, it's all done by stock ownership. (There's no such thing as a "non-equity" shareholder, and it's not possible for S corporation shareholders to allocate ordinary income one way, capital gains another, and charitable contributions in yet another, the way it might be for partners in a partnership (as you'll recall from Study Guide 7).)

Here's the Code section that controls allocations among S corporation shareholders:

§ 1377. Definitions and special rule

- (a) Pro rata share. For purposes of this subchapter -
 - (1) In general. . . . each shareholder's pro rata share of any item for any taxable year shall be the sum of the amounts determined with respect to the shareholder -
 - (A) by assigning an equal portion of such item to each day of the taxable year, and
 - (B) then by dividing that portion pro rata among the shares outstanding on such day.

Questions re Shareholders' Pro Rata Shares

3. In Question 1 above, it was assumed that Anne, Beth, Carl and Doug each would report 25% of the corporation's ordinary business loss and other tax items. Nothing was said in those questions about the number of shares of stock each would own. In order for each of them to properly report 25% of the corporation's loss and other tax items, which of the following would have to be true concerning the amount of stock each owns in the corporation?
 - a. If Doug became the owner of 250 shares of stock on July 1, and the corporation has 1,000 shares outstanding, each would have to own 250 shares.
 - b. If the corporation has 10,000 shares outstanding, each would have to own 2,500 shares.
 - c. Both "a" and "b" are possible. What matters is the percentage of outstanding shares each shareholder owns, not the absolute number of shares.
 - d. The corporation could have 750 shares outstanding, with Anne, Beth and Carl each owning 250 shares, and Doug owning no shares until he has worked for the corporation for an agreed amount of time, *if* the four of them agreed that Doug would be allocated a 25% share in the corporation's gains (or losses) and other tax items, right from the start (something the parties may want to do if they want to be certain that Doug isn't entitled to any corporate assets, should the corporation dissolve, until he has worked for the corporation for an agreed amount of time).
4. Notice that § 1377(a)(1) begins with an S corporation's income and other tax items for the "year" and then divides the *year's* income (etc.) into "equal" portions for each "day" of the year, and then divides each daily portion among the shares outstanding on each day. In our hypothetical, Anne, Beth, Carl and Doug all have been shareholders from day one, so § 1377(a)(1) would not affect any of the questions we've covered so far. Suppose, though, that the corporation was formed on January 2 (and had a January through December tax year), and that only Anne, Beth and Carl were shareholders when the corporation was formed. Suppose that Doug became a shareholder on July 1. And suppose that the corporation had ordinary business income of \$100,000 for its first year of operations (a year that ended December 31), but suppose further that all \$100,000 was actually earned after July 1. If Anne, Beth and Carl each owned 250 shares from January 2, and Doug became the owner of 250 shares of stock on July 1, what portion of the corporation's ordinary business income would be allocated to Doug?
 - a. \$25,000 (i.e., 250 shares/1000 shares x \$100,000).
 - b. \$12,500 (i.e., 250 shares/1000 shares x \$100,000 x 6 months/12 months).

Shareholders' Pro Rata Shares in Family S Corporations

In Study Guide 9, we saw that the Internal Revenue Code limits the extent to which partnerships may be used to allocate gains and losses among family members. The Code also limits the extent to which S corporations may be used to do so.

§ 1366. Pass-thru of items to shareholders

- (e) Treatment of family group. If an individual who is a member of the family . . . of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefor, the Secretary shall make such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital.

Questions re Pro Rata Shares in Family S Corporations

5. Assume that:

- Anne and Doug are husband and wife, and Beth and Carl are their young children.
- Each of the four owns 25% of the stock of the S corporation.
- The real estate and equipment contributed by Beth and Carl were owned originally by their father Doug; and Doug gave Beth and Carl the real estate and equipment as gifts, shortly before Beth and Carl contributed them to the S corporation in return for their S corporation interests.
- The S corporation's profits are allocated among the shareholders in equal 25% shares, and the 25% allocated to Doug reasonably compensates him for the services he renders to the S corporation.

Under these circumstances, will the 25% of the S corporation's income allocated to young Beth and Carl be taxable to them, or will their income be reallocated to Anne and Doug?

- a. It will be taxable to young Beth and Carl.
- b. It will be reallocated, and thus taxable to, Anne and Doug.

6. The facts of Question 5 remain the same, with this one exception:

- The S corporation's profits are (still) allocated among the shareholders in equal 25% shares, *but* the 25% allocated to Doug does *not* reasonably compensate him for the services he renders to the S corporation. In order to hire someone of Doug's experience and skill, the S corporation would have to pay twice as much to someone who was not a shareholder.

Under these circumstances, will the 25% of the S corporation's income allocated to young Beth and Carl be taxable to them, or will their income be reallocated to Doug?

- a. It will be taxable to young Beth and Carl.
- b. As much of Beth and Carl's shares of the S corporation's profits as necessary will be reallocated to Doug so that he receives the fair value of his services, and any balance of S corporation profits will be allocated to Beth and Carl, 25% each.

7. The facts of Question 5 remain the same, with this one exception:
- The S corporation's profits are (still) allocated among the shareholders in equal 25% shares, *but* Beth and Carl did not own or contribute the real estate and equipment. The real estate and equipment were owned and contributed by Anne and Doug. Instead, Beth contributed a bookcase and Carl contributed a wagon, each of which was worth \$25 and both of which actually are used by the S corporation in its business.

Under these circumstances, will the 25% of the S corporation's income allocated to young Beth and Carl be taxable to them, or will their income be reallocated to Anne and Doug?

- a. It will be taxable to young Beth and Carl.
- b. A portion (likely large) of Beth and Carl's shares of the S corporation's profits will be reallocated to Anne and Doug so that profits are allocated in proportion to the relative values of the contributed real estate, equipment, bookcase and wagon.

Limitations on Losses; Basis Adjustments

Although an S corporation's losses are passed through to its shareholders – to be reported and taken advantage of by them on their own individual tax returns – the Code limits the extent of the losses that a shareholder may take advantage of. You'll recall that the Code similarly limits the extent of losses that a partner may take advantage of. (§ 704(d) at Study Guide 6, page 8)

Here are the Code sections that limit the losses that S corporation shareholders may claim:

§ 1366. Pass-thru of items to shareholders

(d) Special rules for losses and deductions

- (1) Cannot exceed shareholder's basis in stock -
The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed . . . -
(A) the adjusted basis of the shareholder's stock in the S corporation .
. . .
- (2) Indefinite carryover of disallowed losses and deductions.-
(A) In general. - Except as provided in subparagraph (B), any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.
(B) Transfers of stock between spouses or incident to divorce. - In the case of any transfer described in section 1041(a) of stock of an S corporation, any loss or deduction described in subparagraph (A) with respect such stock shall be treated as incurred by the corporation in the succeeding taxable year with respect to the transferee.

§ 1367. Adjustments to basis of stock of shareholders, etc.

(a) General rule

- (1) Increases in basis. The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:
 - (A) the items of income described in subparagraph (A) of section 1366(a)(1),
 - (B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1)
- (2) Decreases in basis. The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:
 - (A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,
 - (B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),
 - (C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1)

Questions re Limitations on Losses and on Basis Adjustments

8. When Doug first acquired his S corporation stock, his basis in that stock was \$25,000. In the corporation's first year, it lost \$50,000. If Doug's stock is 25% of the shares outstanding, what are the tax consequences to Doug of the corporation's loss?
 - a. He may deduct \$50,000 (i.e., the amount of the corporation's loss).
 - b. He may deduct \$25,000 (i.e., the amount of his basis in his shares).
 - c. He may deduct \$12,500 (i.e., 25% of the amount of the corporation's loss).
9. Suppose that in year two, the corporation lost an additional \$100,000. If Doug's stock is 25% of the shares outstanding, what are the tax consequences to Doug of the corporation's additional \$100,000 loss?
 - a. He may deduct \$100,000 (i.e., the amount of the corporation's loss).
 - b. He may deduct \$25,000 (i.e., 25% of the amount of the corporation's loss).
 - c. He may deduct \$12,500 (i.e., the amount of basis that he had remaining in his stock at the end of year one, after decreasing his original basis by the amount of his share of the loss in year one).

10. Suppose that in year three, the corporation had ordinary business income of \$100,000. If Doug's stock is 25% of the shares outstanding, what are the tax consequences to Doug of the corporation's income?
- He'll have income of \$100,000 (i.e., the amount of the corporation's income).
 - He'll have income of \$25,000 (i.e., 25% of the amount of the corporation's income).
 - He'll have income of \$12,500 (i.e., 25% of the corporation's income (\$25,000), less the amount of his carried-over loss from year two (\$12,500).)

Distributions to Shareholders

S corporations make distributions to shareholders, just the way C corporations and partnerships do. (I am *not* talking here about salaries paid to S corporation employee/shareholders; we'll get to that just below. Here, I'm talking about straight distributions to shareholders simply because they are shareholders.)

For tax purposes, S corporation shareholders are required to treat the distributions they receive in the following manner:

§ 1368. Distributions

- General rule. A distribution of property made by an S corporation with respect to its stock . . . shall be treated in the manner provided in subsection (b). . . .
- S corporation having no earnings and profits. In the case of a distribution described in subsection (a) by an S corporation which has no accumulated earnings and profits -
 - Amount applied against basis. The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.
 - Amount in excess of basis. If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

Section 1368 should seem familiar to you, because it requires the same treatment of S corporation distributions as is required of distributions made by

- C corporations that do not have earnings and profits (see § 301(a) & (c) at Study Guide 13, page 4), and
- partnerships (see § 731(a)(1) at Study Guide 10, page 1).

If you read § 1368 closely, you noticed that paragraph (b) began with the phrase "S corporation having no earnings and profits" – thus implying that some S corporations do have earnings and profits. Indeed, paragraph (c) of § 1368 begins with the phrase "S corporation having earnings and profits," so some must, but not (in my experience) very many (and that's why I didn't reproduce § 1368(c) above).

The reason that most S corporations do not have earnings and profits is that the income of S corporations is automatically passed through to their shareholders each year – it is not accumulated or otherwise retained – and you'll recall that earnings and profits are decreased by distributions (see § 312(a) at Study Guide 13, page 7). Although "pass-

throughs" and "distributions" are not identical, the concept is the same for tax purposes: both diminish what otherwise would have been a corporation's earnings and profits. And since 100% of an S corporation's income is passed through each year, the pass-through wipes out what otherwise would have been the S corporation's earnings and profits for the year.

The reason that *some* S corporations do have earnings and profits is that some S corporations became S corporations after doing business for a while as C corporations that had accumulated earnings and profits before being converted to S corporations. This is an unusual circumstance, in my experience, because every S corporation I've ever seen elected to become an S corporation when it was first formed. They did, because they anticipated early-year losses (which they wanted to pass through to their shareholders) while hoping for later-year profits (when they would revoke their S elections, as permitted by § 1362(d), and become C corporations).

Question re Distributions to Shareholders

11. When Doug first acquired his S corporation stock, his basis in that stock was \$25,000. In the corporation's first year, it just broke even. Even though the corporation didn't have any earnings, it nevertheless distributed \$10,000 to each shareholder, including Doug. What were the tax consequences to Doug of that distribution?
- None.
 - He had taxable income of \$10,000.
 - The distribution reduced his basis in his stock from \$25,000 to \$15,000.
 - Both "a" and "c" are correct.
12. Suppose that in year two, the corporation again broke even, but nevertheless distributed \$20,000 to each shareholder, including Doug. What were the tax consequences to Doug of that distribution?
- None.
 - He had taxable income of \$20,000.
 - He had taxable income of \$5,000.
 - The distribution reduced his basis in his stock from \$15,000 to \$0.
 - The distribution reduced his basis in his stock from \$15,000 to -\$5,000.
 - None of the above.
- I and II.
 - III and IV.
 - III and V.
 - VI.

Dealing with Items Not Covered in Subchapter S

Subchapter S does not deal with every corporate tax issue that S corporations confront. To deal with those other issues, whatever they might be, Subchapter S incorporates by reference from Subchapter C whichever of its sections might be needed.

§ 1371. Coordination with subchapter C

- (a) Application of subchapter C rules. Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.

Taxing Fringe Benefits

Insofar as fringe benefits are concerned, S corporations are treated like partnerships, not like C corporations.

§ 1372. Partnership rules to apply for fringe benefit purposes

- (a) General rule. For purposes of applying the provisions of this subtitle which relate to employee fringe benefits -
- (1) the S corporation shall be treated as a partnership, and
 - (2) any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership.

So, on the subject of S corporation fringe benefits, I hereby incorporate by reference Study Guide 11, pages 9-14. Although the Schwarz & Lathrope book had nothing to say about partnership fringe benefits, it does have a little to say – one paragraph’s worth – about S corporation benefits. Take a look at the section titled “Other Tax Provisions” beginning at the bottom of page 429. If you read that paragraph too quickly, it may appear to contain an assertion that contradicts some of the conclusions we came to when studying partnership fringe benefits. Focus on what may appear to be this contradiction by answering the following question.

Question re Taxing Fringe Benefits

13. Schwarz & Lathrope say that § 1372 “has the effect of denying the tax advantages of fringe benefits such as group-term life insurance and medical reimbursement plans to disqualified shareholders.” Which of the following is true?
- a. This *does* contradict what we concluded in connection with partnerships, because we concluded that partners are able to get the benefits of group-term life insurance and medical reimbursement plans, because the Code defines partners as “self-employed” and permits self-employed folks to deduct the cost of these items, above-the-line.
 - b. This does *not* contradict what we concluded in connection with partnerships, because we concluded that partners are able to get the benefits of medical insurance (not group-term life insurance, and not medical reimbursement plans which are something different from medical insurance).

Paying Payroll Taxes

Insofar as payroll taxes are concerned, S corporations are treated like C corporations, not partnerships. So, on the subject of payroll taxes, I hereby incorporate by reference Study Guide 13, page 13.10. To see why an S corporation is better than a general partnership, where payroll taxes for non-employee investors are concerned, reread Study Guide 11, pages 11.14 and 11.15, and especially Question 17.

Study Guide 17

TRANSFERRING A BUSINESS

Transferring a Partner's Interest

Selling a Partner's Interest

TRANSFERRING A BUSINESS

We now begin a series of classes in which we'll look at the tax rules that apply to the transfer of an owner's interest in an on-going business, and to the transfer of an entire on-going business. (I say "on-going" business to indicate that we aren't yet talking about the tax consequences of liquidating and shutting down a business; that'll come later.)

Transferring a Partner's Interest

We begin with the tax consequences of transferring a partner's interest in a partnership. As you'll see, there are consequences to the partner who sells his or her interest, and to the person who buys the seller's interest. As you'll also see, the principal consequences are exactly what you would expect them to be, just from what you learned in the Survey course. Naturally, as in other areas of tax law, there are wrinkles too, caused by particular, often partnership-specific, factual circumstances.

Selling a Partner's Interest

Tax Consequences to Selling Partner

Read (in Schwarz & Lathrope)

Pages 534-544 (top three lines only)

Here is the Code section that states the principal consequence (to the selling partner) of selling a partnership interest. The first sentence is exactly what you would expect, and is perfectly understandable (I hope). The only things you'll need to remember, in order to apply the first sentence, are what you learned in the Survey course about selling capital assets – namely, that the *gain recognized* is the *amount realized* less the *seller's basis* in the asset sold (Code § 1001(a) and (b)) – and what you learned earlier in this course about how a partner's basis in his or her partnership interest is determined.

§ 741. Recognition and character of gain or loss on sale or exchange

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items).

The second sentence of the Code section you just read is a wrinkle caused by the fact that some partnerships have "receivables" and "inventory" which are not capital assets. Because they are not, when receivables are collected and inventory is sold by a partnership, they produce ordinary business income that is allocated to the partners and taxed to them at ordinary (not capital gains) rates. The second sentence of § 741, and § 751 to which it

refers, simply prevent partners from converting what would have been income taxed to them at ordinary rates into income taxed at capital gains rates – something they otherwise would have been able to do by the simple expedient of selling their partnership interests before those receivables are collected or inventory is sold. Here is the language of § 751:

§ 751. Unrealized receivables and inventory items

- (a) Sale or exchange of interest in partnership. The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to -
- (1) unrealized receivables of the partnership, or
 - (2) inventory items of the partnership,
- shall be considered as an amount realized from the sale or exchange of property other than a capital asset.
- ...
- (c) Unrealized receivables. For purposes of this subchapter, the term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for -
- (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or
 - (2) services rendered, or to be rendered.
- ...
- (d) Inventory items. For purposes of this subchapter, the term "inventory items" means -
- (1) property of the partnership of the kind described in section 1221(a)(1) [i.e., inventory or other property held for sale to customers in the ordinary course of the partnership's business],
 - (2) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231. . . .

On its face, § 751(a) is perfectly logical and not very difficult. In practice, of course, it takes some arithmetic to implement § 751(a). And that arithmetic requires certain "facts" to be determined, because the section doesn't kick in unless a partner is selling his or her interest *before* the partnership's receivables are collected and inventory sold, and thus before the partnership actually has exact amounts for either. It won't surprise you to learn that the law requires selling partners to use the fair market value of the receivables and inventory.

The law also requires selling partners to allocate their *overall* gain on the sale of their partnership interests

- first to the "gain" on the receivables and inventory, which is taxed to selling partners at ordinary income rates, and then
- second, to the rest of their overall gain as a gain from the sale of a capital asset, taxable to selling partners at capital gains rates.

Here's "the law" that does this:

Reg. § 1.751-1 Unrealized receivables and inventory items

(a) Sale or exchange of interest in a partnership—

- (1) Character of amount realized. To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741. . . . Unrealized receivables and substantially appreciated inventory items are hereafter in this section referred to as "section 751 property". . . .
- (2) Determination of gain or loss. The income or loss realized by a partner upon the sale or exchange of its interest in section 751 property is the amount of income or loss from section 751 property . . . that would have been allocated to the partner . . . if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property . . . immediately prior to the partner's transfer of the interest in the partnership. Any gain or loss recognized that is attributable to section 751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under this paragraph (a)(2) is the transferor's capital gain or loss on the sale of its partnership interest. . . .

More wrinkles are possible, of course. The Schwarz & Lathrope book covers two (at pages 540-542).

One involves the particular capital gains rate to be applied to the capital gains portion of a selling partner's overall gain. You'll recall that although the maximum rate of tax applied to most capital gains is 15%, the sale of some capital assets is taxed at higher rates. Gains from the sale of collectibles (like stamps, coins and art works) are taxed at rates up to 28%, and gains from the sale of depreciated business-use real estate are taxed at rates up to 25%, to the extent of the recaptured depreciation. So, if a partnership owns collectibles or depreciated business-use real estate, the law requires a portion of the selling partner's gain to be attributed to those items, in order to prevent partners from converting what would have been income taxed to them at 28% or 25% capital gains rates into income taxed at 15% capital gains rates – something they otherwise would have been able to do by the simple expedient of selling their partnership interests before the partnership sold the collectibles or real estate.

The second wrinkle involves *which* capital gains rate – long-term or short-term – should be applied to the capital gains portion of a selling partner's overall gain. (This matters, because the short-term capital gains rate is actually the same as the ordinary income rate, and thus is much greater than the long-term capital gains rate.)

As a *general* rule, a partner's holding period in a partnership depends on how long he or she has been a partner: if longer than a year, the partner's interest is a long-term interest; if shorter than a year, the partner's interest is short-term. This isn't always the case though.

- If a partner contributed property for his or her interest less than a year before selling it, but the partner acquired that property more than a year before, the partner's interest in the partnership would be long-term, because the partner's holding period in the property would carry over to his or her interest in the partnership (along with the partner's basis in the contributed property).
- If a partner made a cash contribution for his or her interest more than a year before selling it, and then made an additional cash contribution for an additional interest in the partnership less than a year before selling, part of that partner's interest would be long-term and part would be short-term.
- If a partner contributed property (owned for more than a year) and also contributed cash for his or her partnership interest, less than a year before selling it, the partner would have a split holding period in his or her partnership interest – part long-term and part short-term.

If the partner has holding periods that are both longer than a year and shorter than a year, the law requires the selling partner's gain to be allocated between the long and short-term holding periods. This is done in order to prevent partners from converting what would have been income taxed to them at short-term capital gains – which are the same as ordinary income rates – into income taxed at long-term capital gains rates – something they otherwise could have done by the expedient of selling partnership interests they just happen to have owned for more than a year.

Making the capital gain allocations – What percentage? Long or short-term? – required in these circumstances involves some intricate arithmetic (not hard, just intricate), as illustrated by the Examples in the Schwarz & Lathrope book. For this course, I'm more interested in your being aware of the general principle (that the sale of a partnership interest is treated like the sale of any other capital asset) and the existence of exceptions (that allocations may be necessary) than I am in your being able to do the arithmetic.

Questions re Tax Consequences to Selling Partner

1. Anne has decided to sell her interest in the partnership. Suppose that Anne's basis in her partnership interest is still \$100,000. (This would be so, you'll recall, if the partnership had ordinary business income, and then distributed to Anne her share of that income.) Assume also that the partnership is a service business, such as a travel agency or employment agency, so the partnership doesn't have any inventory. And suppose that the business does not have any receivables. If Anne sells her partnership interest to Evan for \$150,000, what are the tax consequences to her? (Disregard how long after forming the partnership the sale will take place. We'll get to that in Question 4.)
 - a. She will have capital gains of \$150,000.
 - b. She will have capital gains of \$50,000.
 - c. She will have ordinary income of \$150,000.
 - d. She will have ordinary income of \$50,000.

2. Would your answer to Question 1 be different if Anne sold her partnership interest to Beth, Carl or Doug (one of the existing partners), rather than to Evan (a new partner)?
 - a. Yes, the rule concerning the treatment of the sale or exchange of partnership interests applies only to sales to new partners, not to sales to existing partners.
 - b. No, the rule concerning the treatment of the sale or exchange of partnership interests applies to sales to existing partners as well as new partners.

3. Anne has decided to sell her interest in the partnership. Suppose that Anne's basis in her partnership interest is still \$100,000. (This would be so, you'll recall, if the partnership had ordinary business income, and then distributed to Anne her share of that income.) Assume now that the partnership is a wholesale distribution business, so the partnership has inventory at the time of the sale, which if sold by the partnership would produce profits of \$10,000 (for the whole partnership). Suppose also that the partnership has \$15,000 in receivables. If Anne sells her partnership interest to Evan for \$150,000, what are the tax consequences to her? (Disregard how long after forming the partnership the sale will take place. We'll get to that in Question 4.)
 - a. She will have capital gains of \$50,000.
 - b. She will have ordinary income of \$25,000 and capital gains of \$25,000.
 - c. She will have ordinary income of \$6,250 and capital gains of \$43,750.
 - d. She will have ordinary income of \$50,000.

4. Anne has owned her partnership interest for *more than a year* and has decided to sell it. Suppose that Anne's basis in her partnership interest is still \$100,000. (This would be so, you'll recall, if the partnership had ordinary business income, and then distributed to Anne her share of that income.) Assume also that the partnership is a service business, such as a travel agency or employment agency, so the partnership doesn't have any inventory. And suppose that the business does not have any receivables. If Anne sells her partnership interest to Evan for \$150,000, what are the tax consequences to her?
 - a. She will have capital gains of \$150,000, taxed at the 15% long-term capital gains rate.
 - b. She will have capital gains of \$50,000, taxed at the 15% long-term capital gains rate.
 - c. She will have capital gains of \$150,000, taxed at short-term capital gains rates which are the same as her ordinary income tax rate.
 - d. She will have capital gains of \$50,000, taxed at short-term capital gains rates which are the same as her ordinary income tax rate.

5. What would your answer to Question 4 be if Anne sold her partnership interest *during the first year* she owned that interest?
 - a. She will have capital gains of \$150,000, taxed at the 15% long-term capital gains rate.
 - b. She will have capital gains of \$50,000, taxed at the 15% long-term capital gains rate.
 - c. She will have capital gains of \$150,000, taxed at short-term capital gains rates which are the same as her ordinary income tax rate.
 - d. She will have capital gains of \$50,000, taxed at short-term capital gains rates which are the same as her ordinary income tax rate.

6. If Beth sells her partnership interest to Frank *during the first year* she owns it for \$150,000, what will the tax consequences to Beth be, given the following facts. Beth's basis in that interest was \$50,000, because she received her interest in return for contributing real estate that at the time she contributed it: she had owned for more than a year; in which her basis was \$50,000, because that is what she paid for the real estate when she first bought it; that had a fair market value of \$100,000. The partnership had no inventory or receivables when she sold her interest.
 - a. She will have capital gains of \$150,000, taxed at the 15% long-term capital gains rate.
 - b. She will have capital gains of \$100,000, taxed at the 15% long-term capital gains rate.
 - c. She will have capital gains of \$150,000, taxed at short-term capital gains rates which are the same as her ordinary income tax rate.
 - d. She will have capital gains of \$50,000, taxed at short-term capital gains rates which are the same as her ordinary income tax rate.

Tax Consequences to Buying Partner

Read (in Schwarz & Lathrope)

Pages 544-550

The primary tax consequence to the buying partner – i.e., the person who buys the selling partner's interest – is minimal and not surprising. Buying a partnership interest does not result in a gain or loss to the buyer. The issue that needs to be addressed is the buyer's basis in the partnership interest he or she has purchased. (Remember: this part of the course deals with buying a partnership interest from someone who already is a partner in an existing partnership. It does not involve investing in a partnership that is being formed. We covered that topic in Study Guide 2.) Here is the law that covers the buying partner's basis:

§ 742. Basis of transferee partner's interest

The basis of an interest in a partnership acquired other than by contribution shall be determined under part II of subchapter O (sec. 1011 and following).

§ 1012. Basis of property - cost

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapter[] . . . K (relating to partners and partnerships). . . .

Notice that § 742 sends readers to § 1012 (i.e., “sec. 1011 and following”); and § 1012 sends readers back to § 742 (i.e., “subchapter K” which is where § 742 is located). This isn’t as circular as it appears at first, because in addition to § 742, subchapter K contains § 722 which deals with a partner’s basis in his or her partnership interest *if* the partner acquires that interest by contributing cash or property *to the partnership*, while § 742 deals with a partner’s basis in his or her partnership interest if the partner acquires that interest by buying it from *another partner*.

Taken together, sections 742 and 1012 mean that the buyer’s basis in a partnership interest he or she purchased from another partner is whatever amount the buyer paid for that interest.

Questions re Tax Consequences to Buying Partner

7. Given the facts stated in Question 6, what will Frank’s basis be in the partnership interest he purchased from Beth?
 - a. \$50,000, because that was Beth’s basis in the interest she sold him.
 - b. \$100,000, because that is the amount of gain Beth realized from the sale of the interest to him.
 - c. \$150,000, because that is the amount he paid for the interest he purchased from Beth.

Consequences to Buying Partner of Difference Between Buyer’s Outside Basis and Partnership’s Inside Basis

Notice that because the buying partner’s basis in his or her partnership interest – what is known as the “outside” basis – is what the buyer paid for the interest, it is possible – even probable – that

- the buying partner will have a different (outside) basis in his or her interest in the partnership than
- the partnership’s (inside) basis in the buying partner’s interest in the partnership’s assets.

If this sounds vaguely familiar to you, that’s because we covered something similar in Study Guide 11, when we looked at the consequences of a partnership distributing cash to a partner in an amount that exceeds his or her basis in the partnership, or distributing property to a partner in which the partnership’s basis exceeds the partner’s basis in the partnership. You’ll recall that a “section 754 election” is the way to avoid the undesirable tax consequences of such distributions. And now we’ll see that a “section 754 election” also is the way to avoid the potentially undesirable tax consequences of a variance between

- a buyer’s basis in the partnership and
- the partnership’s basis in the buying partner’s interest in partnership property.

You now know (from Study Guide 11) *what* a “section 754 election” is. Our task here is to figure out when and why a partnership would make such an election, in connection with a partner’s sale of his or her interest in the partnership.

Taking this step-by-step, we see that if the partnership does *not* make a section 754 election, the partnership’s basis in its property is *not* adjusted when a partner sells his or her interest:

§ 743. Special rules where section 754 election or substantial built-in loss

- (a) General rule. The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange . . . unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership. . . .

However, if a partnership does make a section 754 election, its basis in its property is adjusted when a partner sells his or her interest:

§ 754. Manner of electing optional adjustment to basis of partnership property

If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, . . . in the case of a transfer of a partnership interest, in the manner provided in section 743. . . .

The adjustment is done in a particular fashion – namely, “in the manner provided in section 743.” So here’s how the adjustment is done:

§ 743. Special rules where section 754 election or substantial built-in loss

- (b) Adjustment to basis of partnership property. In the case of a transfer of an interest in a partnership by sale or exchange . . . , a partnership with respect to which the election provided in section 754 is in effect . . . shall -
- (1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or
 - (2) decrease the adjusted basis of the partnership property by the excess of the transferee partner’s proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.
- Under regulations prescribed by the Secretary, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner’s proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital. . . .
- (c) Allocation of basis. The allocation of basis among partnership properties where subsection (b) is applicable shall be made in accordance with the rules provided in section 755.

§ 755. Rules for allocation of basis

(a) General rule. Any increase or decrease in the adjusted basis of partnership property under section . . . section 743(b) (relating to the optional adjustment to the basis of partnership property in the case of a transfer of an interest in a partnership) shall . . . be allocated -

(1) in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.

In plain English, this means that if a partnership makes a 754 election, the partnership increases (or decreases) its own basis in a portion of its property in order to match the buying partner's basis in his or her partnership interest. The portion of partnership property whose basis gets adjusted is the same as the buying partner's percentage interest in the partnership capital. The adjustment is allocated (on the partnership's balance sheet) entirely to the buying partner. If the partnership owns several items of property (as is often the case), the adjustment in the basis of those items of property is allocated among them so as to reduce the difference between their bases and their fair market values.

Here are the consequences of making or not making a 754 election:

- *Partnership has not made a 754 election*

If a buying partner pays a selling partner more for the seller's partnership interest than the partnership's basis in the buying partner's share of the partnership's assets, and no election was made, the partnership's basis in its assets will remain unchanged. Therefore, if the partnership later sells those assets at a gain, all of that gain will be allocated among (and will be taxable to) all of the partners, including the buying partner, even though the buying partner paid the selling partner for some or all of that gain. The buying partner, in other words, will be unable to offset any of the amount he or she paid for the partnership interest against his or her share of the gain from the partnership's sale of assets the partnership owned when the buying partner bought his or her interest.

- *Partnership has made a 754 election*

If a buying partner pays a selling partner more for the seller's partnership interest than the partnership's basis in the buying partner's share of the partnership's assets, and the partnership did make an election, the partnership's basis in a portion of its assets will be increased by

- the amount the buying partner paid for his or her interest *less*
- the partnership's basis in the buying partner's portion of partnership assets.

In this fashion, the buying partner's basis in his or her portion of the partnership's assets will become equal to what the buying partner paid for them. Therefore, if the partnership later sells those assets at a gain, the buying partner's share of the gain will be smaller (higher basis = smaller gain), and thus the gain allocated to the buying partner will be smaller.

More Questions re Tax Consequences to Buying Partner

8. Beth sold her partnership interest to Frank for \$150,000. Beth's basis in that interest was \$50,000, because she received her interest in return for contributing real estate that at the time she contributed it: she had owned for more than a year; in which her basis was \$50,000, because that is what she paid for the real estate when she first bought it; that had a fair market value of \$100,000. The partnership took no depreciation on the real estate it received from Beth, nor did it do anything else that affected the partnership's basis in that real estate. As a result, the partnership's basis in the real estate was still \$50,000 when Frank became a partner. Shortly after Frank became a partner, the partnership sold the real estate for \$100,000, *without having made a section 754 election*. Here are the balance sheets that illustrate these events:

Balance Sheet when partnership was first formed

<u>ASSETS</u>			<u>LIABILITIES/PARTNERS' CAPITAL</u>		
	<u>Adj Basis</u>	<u>Book Value</u>		<u>Adj. Basis</u>	<u>Capital Account</u>
Cash	\$100,000	\$100,000	Liabilities	\$0	\$0
Real Estate	\$ 50,000	\$100,000	Capital		
Equipment	\$ 25,000	\$100,000	Anne	\$100,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Beth	\$ 50,000	\$100,000
Totals	\$275,000	\$400,000	Carl	\$ 25,000	\$100,000
			Doug	<u>\$100,000</u>	<u>\$100,000</u>
			Totals	\$275,000	\$400,000

Balance Sheet after Beth sold her partnership to Frank for \$150,000 and before partnership sold anything (or did any business)

<u>ASSETS</u>			<u>LIABILITIES/PARTNERS' CAPITAL</u>		
	<u>Adj Basis</u>	<u>Book Value</u>		<u>Adj. Basis</u>	<u>Capital Account</u>
Cash	\$100,000	\$100,000	Liabilities	\$0	\$0
Real Estate	\$ 50,000	\$100,000	Capital		
Equipment	\$ 25,000	\$100,000	Anne	\$100,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Frank	\$150,000	\$100,000
Totals	\$275,000	\$400,000	Carl	\$ 25,000	\$100,000
			Doug	<u>\$100,000</u>	<u>\$100,000</u>
			Totals	\$375,000	\$400,000

Balance Sheet after Beth sold her partnership to Frank for \$150,000, and after it sold the real estate for \$100,000 realizing a gain of \$50,000 (but before partnership did any business)

<u>ASSETS</u>			<u>LIABILITIES/PARTNERS' CAPITAL</u>		
	<u>Adj Basis</u>	<u>Book Value</u>		<u>Adj. Basis</u>	<u>Capital Account</u>
Cash	\$200,000	\$200,000	Liabilities	\$0	\$0
Real Estate	\$ 0	\$0	Capital		
Equipment	\$ 25,000	\$100,000	Anne	\$100,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Frank	\$150,000	\$150,000
Totals	\$325,000	\$400,000	Carl	\$ 25,000	\$100,000
			Doug	<u>\$100,000</u>	<u>\$100,000</u>
			Totals	\$375,000	\$450,000

What are the tax consequences, if any, to Frank as a result of the partnership's sale of the real estate?

- a. The partnership will realize a \$50,000 gain, but none of that gain will be allocated to Frank because he was not a partner when the property appreciated in value (since it was already worth \$100,000 when Beth first contributed the property to the partnership).
 - b. The partnership will realize a \$50,000 gain, 25% of which – \$12,500 – will be allocated *and thus taxable* to Frank, because by the time the real estate was sold, he had purchased Beth's 25% interest, even though the \$150,000 he paid Beth for her interest was based, in part, on the fact that the partnership owned real estate worth \$100,000.
9. What would your answer to Question 8 be, if the partnership had made a section 754 election before it sold the real estate?
- a. The partnership will realize a \$50,000 gain, but none of that gain will be allocated to Frank because he was not a partner when the property appreciated in value (since it was already worth \$100,000 when Beth first contributed the property to the partnership).
 - b. The partnership will realize a \$50,000 gain, 25% of which – \$12,500 – will be allocated *and thus taxable* to Frank, because by the time the real estate was sold, he had purchased Beth's 25% interest, even though the \$150,000 he paid Beth for her interest was based, in part, on the fact that the partnership owned real estate worth \$100,000.
 - c. The partnership will increase its basis in 25% of the real estate so that it equals the portion of the amount that Frank paid to Beth attributable to the real estate (an amount that would require us to know what percentage of the total value of the partnership was attributable to the real estate). The increase in the partnership's basis in 25% of the real estate will be allocated entirely to Frank. Thus, when the real estate is sold, the portion of the partnership's gain allocated to Frank will be less than the portion allocated to the other partners.
 - d. The partnership will realize a \$50,000 gain, all of which will be allocated to Frank. The \$50,000 allocated to Frank will increase his Outside Basis in the partnership from \$150,000 to \$200,000. The \$50,000 allocated to Frank also increased his Capital Account from \$100,000 to \$150,000. However the \$50,000 allocated to Frank did not result in his realizing a gain, because as a result of the 754 election, Frank's inside basis in the real estate was increased \$50,000, and that increase offset the \$50,000 gain that was allocated to him.

Basis Adjustment Even Without 754 Election

One last point: You may have noticed that the title of § 743 indicates that the partnership's basis in its property gets adjusted if a 754 election is made "or" if the partnership has a "substantial built-in loss" after a partnership interest is sold. The version of § 743 reproduced above was edited to focus on the "section 754 election." Here now is § 743, edited to focus the "built-in loss" provision:

§ 743. Special rules where section 754 election or substantial built-in loss

- (a) General rule. The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange . . . unless the partnership has a substantial built-in loss immediately after such transfer.
- (b) Adjustment to basis of partnership property. In the case of a transfer of an interest in a partnership by sale or exchange . . . , a partnership . . . which has a substantial built-in loss immediately after such transfer shall -
 - (1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or
 - (2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

Under regulations prescribed by the Secretary, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital. . . .

. . .
(d) Substantial Built-In Loss.-

- (1) In general.-For purposes of this section, a partnership has a substantial built-in loss with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in the partnership property exceeds by more than \$250,000 the fair market value of such property.

Notice that if there is a "substantial built-in loss," there will be an automatic adjustment of the basis of a portion of the partnership's assets, even if a section 754 election has *not* been made.

Study Guide 18

TRANSFERRING A BUSINESS

Transferring a Partner's Interest

Liquidating a Partner's Interest

Liquidating a Partner's Interest

The Code distinguishes between, and treats differently,

- the sale of a partner's interest to a new partner or to an existing partner, and
- the acquisition of a partner's interest by the partnership itself.

We covered the tax consequences of a sale to a new or existing partner in Study Guide 17. Now we will look at the tax consequences of the acquisition of a partner's interest by the partnership itself. The Code makes this distinction by defining "liquidation" in § 761 and by attaching tax consequences to payments "made in liquidation" in § 736. Here is the definition:

§ 761. Terms defined

- (d) Liquidation of a partner's interest. For purposes of this subchapter, the term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership.

Section 736 is on the next page. As you read it, notice two things.

First, § 736 talks about "retiring" partners and "deceased" partners. Don't get hung up on the word "retiring." Section 736 applies to any partner who withdraws entirely from a partnership, even if the partner is decades short of actual retirement (in the eligible-for-Social-Security sense). For example, a 36-year-old law firm partner who leaves his firm and the day-to-day practice of law in order to become a full-time law professor is a "retiring partner" insofar as § 736 is concerned, even though (I can tell you from personal experience) that "retiring partner" is far from actual retirement (and in many ways is only then beginning to "work"). Also, for this Study Guide, don't get hung up on "deceased" partners. We will cover the tax consequences of transferring the partnership interest of a deceased partner in Study Guide 19. Many of those consequences will be covered by § 736, so much of what we will cover in this Study Guide 18 will be relevant when we get to Study Guide 19. Right now, though, we'll be focusing on "retiring" partners, who – you now understand – may not actually be "retiring" at all, in the everyday sense of that word.

Second, § 736 is a candidate for an award as "the Internal Revenue Code section containing the most double-negatives." Subparagraph "(b)" contains what is actually the *general rule* for the tax treatment of the liquidation of a partner's interest; but it contains a "special rule" for the treatment of payments for *certain* things, which special rule applies only to certain kinds of partnerships and only to certain kinds of partners! Subparagraph "(a)" appears to cover a broad category of payments, but it actually applies to just a couple kinds of payments!

So, the primary task for this Study Guide is to sort out which payments are covered by which subparagraph of § 736, and to see what tax consequences each subparagraph imposes on the liquidating (liquidated?) partner and on the partnership. When we've done that, we'll be able to compare those tax consequences with the consequences that would result from structuring the entire transaction as a sale by the departing partner directly to the remaining partners, rather than as a liquidation, because doing it that way is legally permissible and will result in different tax consequences. In other words, there's some advance planning that's possible.

§ 736. Payments to a retiring partner or a deceased partner's successor in interest

- (a) Payments considered as distributive share or guaranteed payment. Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered -
 - (1) as a *distributive share* to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or
 - (2) as a *guaranteed payment* described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.
- (b) Payments for interest in partnership
 - (1) General rule. Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined . . . to be made in exchange for the interest of such partner in partnership property, be considered as a *distribution by the partnership* and not as a distributive share or guaranteed payment under subsection (a).
 - (2) Special rules. For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for -
 - (A) *unrealized receivables* of the partnership (as defined in section 751(c)), or
 - (B) *good will* of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.
 - (3) Limitation on application of paragraph (2). Paragraph (2) shall apply only if -
 - (A) capital is not a material income-producing factor for the partnership, and
 - (B) the retiring or deceased partner was a general partner in the partnership.

[Emphasis added]

Section 736(b) Payments

Tax Consequences to Partner

Read (in Schwarz & Lathrope)

Pages 578-581

The general rule concerning the tax treatments of a payment made by a partnership to a retiring partner is stated in § 736(b)(1). In plain English, it says that if the payment is in exchange for the partner's interest in the partnership's property, the payment is treated

- *as though* it were a "distribution" by the partnership to the partner,
- *rather than* as a "distributive share" or "guaranteed payment."

To appreciate the significance of this distinction, it's necessary to remember

- how a *distribution* differs from a *distributive share*, and
- how a *distribution* differs from a *guaranteed payment*.

We studied *distributions*, and their tax consequences, in Study Guide 10. We studied *distributive shares*, and their tax consequences, in Study Guides 7 and 8. And we looked (perhaps too briefly) at guaranteed payments in Study Guide 9. So, refresh your recollection of what you learned in those Study Guides, with this one caveat: in Study Guide 10, when we looked at the consequences of *property* distributions, we studied paragraph (a) of Code § 732 – a paragraph that deals with property distributions "*other than* in liquidation" (emphasis added). In this Study Guide, we'll look at paragraph (b) of Code § 732 – the paragraph that deals with property distributions "in liquidation."

§ 732. Basis of distributed property other than money

- ...
- (b) Distributions in liquidation. The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

You'll recall that

- distributions are cash or property *actually distributed* to partners,
- distributive shares are the portions of partnership income (and other tax items) that are *allocated* to partners, and
- guaranteed payments are payments made to partners (for services or the use of capital), without regard to the partnership's income.

While it's difficult (and often inaccurate) to summarize the tax consequences of distributions, distributive shares and guaranteed payments, the significance of § 736(b)(1) may begin to come into focus for you, if you recall that

- distributions of
 - cash to a partner are not taxed to the recipient (unless, and to the extent that, the amount of cash exceeds his or her basis in the partnership),
 - property to a partner are not taxed to the recipient (though in liquidating distributions, as a result of § 732(b), the partner's basis in the property received becomes equal to what his or her basis in the partnership was, as reduced by any cash received),
- distributive shares are taxed to the partner to whom they are allocated, and
- guaranteed payments are taxed to the partner to whom they are made

In other words, as a general rule, a retiring partner

- will pay tax on payments received from the partnership if (and to the extent) the partner receives cash in excess of his or her partnership basis, and
- if the partner receives property too (or instead), the partner's basis in that property will be the same as his or her basis in the partnership (as that basis may have been reduced by cash payments), and the partner will pay tax, later, when he or she sells that property.

Questions re Tax Consequences to Partner of Receiving § 736(b) Payments

1. Beth wants to "retire" from the partnership, and the other partners are willing to have the partnership "liquidate" her interest by paying her \$75,000 in cash. If Beth's basis in the partnership is still \$50,000, what are the tax consequences to her?
 - a. There are no tax consequences.
 - b. She will have taxable income of \$50,000 – the amount of her basis in the partnership.
 - c. She will have taxable income of \$25,000 – the amount by which the payment she receives from the partnership exceeds her basis in the partnership.
 - d. She will have taxable income of \$75,000 – the amount of the payment she receives from the partnership.
2. Beth wants to "retire" from the partnership, and the other partners are willing to have the partnership "liquidate" her interest by giving her back her real estate, which by now has a fair market value of \$75,000. If Beth's basis in the partnership is still \$50,000, what are the tax consequences to her?
 - a. There are no tax consequences.
 - b. She will not have taxable income when she "retires," but her basis in the real estate she receives will be \$50,000, so if she sells the real estate for the \$75,000 it is worth when she gets it back, she will have \$25,000 in gain then.
 - c. She will not have taxable income when she "retires," and her basis in the real estate she receives will be \$75,000 – its fair market value when she receives it – so if she sells the real estate for the \$75,000 it is worth when she gets it back, she won't have taxable income then either.
 - d. She will have taxable income of \$25,000 when she "retires" – the amount by which the fair market value of the real estate she receives exceeds her basis in the partnership.

3. Beth wants to “retire” from the partnership, and the other partners are willing to have the partnership “liquidate” her interest by paying her \$25,000 in cash and giving her back her real estate, which by now has a fair market value of only \$50,000. If Beth’s basis in the partnership is still \$50,000, what are the tax consequences to her?
 - a. There are no tax consequences.
 - b. She will not have taxable income when she “retires,” but her basis in the real estate she receives will be \$25,000, so if she sells the real estate for the \$50,000 it is worth when she gets it back, she will have \$25,000 in gain then.
 - c. She will not have taxable income when she “retires,” and her basis in the real estate she receives will be \$50,000 – its fair market value when she receives it – so if she sells the real estate for the \$50,000 it is worth when she gets it back, she won’t have taxable income then either.
 - d. She will have taxable income of \$25,000 when she “retires” – the amount of the cash she receives – and her basis in the real estate she receives will be \$25,000, so if she sells the real estate for the \$50,000 it is worth when she gets it back, she will have an additional \$25,000 in gain then.

Tax Consequences to Partnership

Read (in Schwarz & Lathrope)

Pages 581-584

The liquidation of a partner’s interest is not a taxable event for the partnership. In fact, the liquidation of a partner’s interest doesn’t even trigger an adjustment to the partnership’s basis in its assets, unless the partnership has made the “section 754 election” we looked at earlier. You can see all this from the following Code sections (which will be familiar to you from your reading of Study Guide 11 concerning distributions to partners):

§ 731. Extent of recognition of gain or loss on distribution

- (b) Partnerships. No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.

§ 734. Optional adjustment to basis of undistributed partnership property

- (a) General rule. The basis of partnership property shall not be adjusted as the result of a distribution of property to a partner unless the election, provided in section 754 (relating to optional adjustment to basis of partnership property), is in effect with respect to such partnership. . . .
- (b) Method of Adjustment.— In the case of a distribution of property to a partner by a partnership with respect to which the election provided in section 754 is in effect . . . , the partnership shall-
 - (1) increase the adjusted basis of partnership property by -
 - (A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1), and
 - (B) in the case of distributed property to which section 732(a)(2) . . . applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution . . . over the basis of the distributed property to the distributee, as determined under section 732. . . .

§ 754. Manner of electing optional adjustment to basis of partnership property

If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734. . . .

As before, the purpose of a “section 754 election” is to permit the adjustment of a partnership’s basis in its remaining property, when the partnership has distributed property to a partner – in this Study Guide, to a “retiring” partner – under circumstances where the partner’s basis in the property he or she receives is different from the basis that property had when it was in the hands of the partnership. In a nutshell, the adjustment is designed to permit the remaining partners to avoid paying tax on the same amount of gain that the retiring partner will have to pay tax on, as a result of the retiring partner having a different basis in property he or she received than the partnership had in that property.

Section 736(a) Payments

Read (in Schwarz & Lathrope)

Pages 584-585

Now that we’ve covered the “general rule” concerning the taxation of liquidating a partner’s interest, let’s turn to the special cases, the tax treatment of which is dictated by § 736(a).

Section 736(a) payments are treated as “distributive shares” or “guaranteed payments.” And we already know that both of those are taxable income to those partners who receive them. (See page 3 of this Study Guide.) Now all we need to figure out is what kinds of payments are § 736(a) payments (rather than § 736(b) payments). The answer is given to us by §736(b) itself.

Section 736(a) payments are payments that:

- are *not* in exchange for a partner’s interest in partnership *property* [§ 736(b)(1)]
or
- are payments to a general partner in a personal *service* partnership [§ 736(b)(3)] that
 - *are* in exchange for the partner’s interest in the partnership’s unrealized receivables [§736(b)(2)(A)]
or
 - *are* in exchange for the partner’s interest in the partnership’s goodwill *if* the partnership agreement did *not require* payment for goodwill [§736(b)(2)(B)].

Question re Tax Consequences to Partner of Receiving § 736(a) Payments

4. We already know what the consequence is to a partner who receives a § 736(a) payment: the payment is taxable income to that partner. The question is: can you come up with a hypothetical (involving Anne, Beth, Carl and Doug, or others if need be) that illustrates the circumstances under which payments would be § 736(a) payments?

Liquidation vs. Sale

Read (in Schwarz & Lathrope)

Page 589

Question re Liquidation vs. Sale

5. Under what circumstances would some partners prefer liquidation and others prefer sale, and who would prefer which?

Study Guide 19

TRANSFERRING A BUSINESS

Transferring a Partner's Interest

Transferring the Interest of a Deceased Partner

Transferring the Interest of a Deceased Partner

The reading assignment in Schwarz & Lathrop (below) is short, and, for that reason, it doesn't fully illuminate the tax complications that arise when a partner dies and his or her partnership interest is transferred to someone else. One of the reasons that the death of a partner creates complications is that there are several ways in which the transfer of the deceased partner's interest may occur, and they aren't all taxed alike.

If there is *no* pre-death agreement concerning what will happen to a partner's interest if a partner dies, any of the following three things could happen. In all three cases, the deceased partner's interest passes to his or her successor (via the deceased partner's estate which is managed by the decedent's administrator or executor) and is owned by the decedent's successor, unless and until the successor transfers it to someone else.

1. *Successor becomes and continues to be a partner.* The deceased partner's interest in the partnership may pass to a successor who simply steps into the "shoes of the deceased partner" (so to speak) and continues on as a partner. (Who, exactly, that "successor" is depends on state law, not federal tax law. The successor could be: a beneficiary named in the deceased partner's will, if the decedent left a will; or an heir designated by state law, if the decedent didn't leave a will; or even a surviving spouse, regardless of what the decedent's will said, if the decedent's property is marital property and state law gives surviving spouses absolute rights in marital property.)
2. *Successor sells partnership interest (pursuant to post-death deal).* The deceased partner's successor might sell the partnership interest to someone else (an existing partner, or a new partner), in a deal made by the *successor after* the deceased partner's death.
3. *Partnership liquidates deceased partner's interest (pursuant to post-death deal).* The partnership might liquidate the interest of the deceased partner's *successor*, in a deal made by the *successor after* the deceased partner's death.

If there *is* a pre-death agreement concerning what will happen to a partner's interest if a partner dies, either of the following two things could happen, depending on what the pre-death agreement provides. In both cases, the deceased partner's interest does *not* pass to the his or her successor. Instead, the deceased partner's interest passes directly from the decedent (technically, from the decedent's estate which is managed by his or her administrator or executor) to the buyer.

4. *Surviving partners buy deceased partner's interest (pursuant to pre-death Buy-Sell Clause in partnership agreement).* The deceased partner's interest might be purchased by the surviving partners, in a deal made among the partners including the *deceased partner before* he or she died. In this case, the deceased partner's interest never passes to the deceased partner's successor, though the liquidation proceeds do go to the successor.
5. *Partnership liquidates deceased partner's interest (pursuant to pre-death Liquidation Clause in the partnership agreement).* The deceased partner's interest might be

liquidated by the partnership, in a deal made by the partnership and the *deceased* partner *before* he or she died. The deceased partner's interest is liquidated, and that interest never passes to the deceased partner's successor, though the liquidation proceeds do go to the successor.

The reading assignment (below) describes the sections of the Code and Regulations that determine the consequences of these transfers. The Code sections determine such things as:

- When the tax year closes for
 - the partnership, which is important because income (and other tax items) must be calculated and allocated to the deceased partner as of that date
 - the deceased partner, which is important because income (and other tax items) received and allocated by that date must be reported on the deceased partner's final tax return, while income received and allocations made after that date must be taxed to someone else.
- What sort of income is *deemed to be* post-death income (called "Income in Respect of a Decedent") that gets taxed to someone else, even if, at first glance, it doesn't look like post-death income.
- What happens when someone acquires a deceased partner's interest in the partnership under circumstances that give that person a different "outside" basis in the partnership interest than the partnership's "inside" basis in that person's share of partnership assets.

This Study Guide addresses these issues:

- *What portion of a partnership's income (or loss, and other tax items) are taxable to the deceased partner (on his or her final tax return), and what portion are taxable to whoever becomes the owner of the decedent's interest in the partnership.* This issue is dealt with by Code sections 443(a) and 706(c) which specify when the tax years of the decedent and the partnership end. (SG 19.3 and 19.4) The application of these Code sections is illustrated by Question 1 (SG 19.8).
- *What happens when a partnership earns income before a partner dies, but does not collect that income until after the partner's death.* This issue is addressed by Code section 691(a) which is the codification of the "Income in Respect of a Decedent" doctrine. (SG 19.5) Question 1 also illustrates the application of this Code section.
- *What the new partner's basis is in the partnership interest acquired from a deceased partner.* This depends on whether the new partner *inherited* the partnership interest from the deceased partner, or *purchased* the partnership interest from the decedent's estate. It also depends on whether the partnership interest acquired from the deceased partner included a right to collect Income in Respect of a Decedent. These issues are addressed in Code sections 691, 753, 736 and 1014 (SG 19.6 and 18.2). Questions 2 and 3 (SG 19.9-19.10) illustrate the application of these sections.

Read (in Schwarz & Lathrope)

Pages 598-602

Tax Year

Here is the Code section that explains the tax circumstances of the *deceased partner* for the final year of his or her life. The section means that the decedent's final tax year ends on the day he or she dies – not on December 31st of that year (even though the tax year for individuals is the January-December calendar year).

§ 443. Returns for a period of less than 12 months

- (a) Returns for short period. A return for a period of less than 12 months (referred to in this section as "short period") shall be made under any of the following circumstances:
- ...
- (2) Taxpayer not in existence for entire taxable year. When the taxpayer is in existence during only part of what would otherwise be his taxable year.

Section 443 is significant, because it means that the deceased partner's final tax return must include all income received by and allocated to the decedent up to the date of his or her death, but not any income received (or deemed to be received) after the decedent's death by his or her successor.

Ordinarily, a partnership's income (and other tax items) are calculated and allocated to its partners at the end of the *partnership's* tax year. So if § 443 were all there were to it, allocations made to a deceased partner for the partnership tax year in which the partner died would not be reported by the deceased partner on his or her final tax return; they would be reported by the deceased partner's successor.

For example, suppose that Peter is a partner in a partnership that (like Peter) has a taxable year ending on December 31st. *If* § 443 were all there were to this issue, and Peter died on September 30th, his final tax return would report his income from January through September; and because the partnership's income (and other tax items) for the year of Peter's death would not have been allocated to him by September 30th, all the partnership's income (etc.) for that year would be allocated to Peter's successor at the end of the partnership's tax year on December 31st.

However, § 443 is *not* all there is to it. The Code contains § 706(c) too:

§ 706. Taxable years of partner and partnership

(c) Closing of partnership year

- (1) General rule. *Except . . . as provided in paragraph (2) of this subsection, the taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership.*
- (2) Treatment of dispositions
 - (A) Disposition of entire interest. The taxable year of a partnership shall close *with respect to a partner whose entire interest in the partnership terminates* (whether by reason of death, liquidation, or otherwise).

[Emphasis added]

Section 706(c) adds this to the mix: If a partner dies, the partnership is required to calculate its income (etc.) as of the partner's date of death, and the deceased partner's share up to that date is allocated to him or her. Those allocations are reported on the deceased partner's final tax return. So, to return to our example: suppose that Peter is a partner in a partnership that (like Peter) has a taxable year ending on December 31st. Because of § 706(c), the partnership would calculate Peter's share of the partnership's income (etc.), and would allocate that share to him, *as of his date of death* – in this example, September 30th – and Peter's final tax return – which would be for the "short period" from January through September – would include those allocations.

Notice that if the partnership's tax year ends June 30th (rather than December 31st), Peter's final tax return (for January through September of his last year) will include the income (etc.) the partnership allocated to him for the partnership tax year that ended the June 30th prior to his death, plus the income (etc.) allocated to him for July through September.

The partnership's tax year doesn't close for the still-living partners. The partnership keeps its same tax year for the living partners and for the deceased partner's successor. The successor's share of income (etc.) earned by the partnership *after* the deceased partner's death is allocated to the deceased partner's successor, to be reported by the successor on his or her tax return.

Income in Respect of a Decedent

In plain English, "income in respect of a decedent" is income received by a decedent's *successor* that was never included in the decedent's own taxable income, because even though the decedent earned the income while still alive, the income wasn't actually received until *after* the decedent died. The classic example is income earned for services rendered by a cash-basis taxpayer who died before collecting that income, so when it was finally received, it went to the decedent's *successor*. The "income in respect of a decedent" doctrine requires the decedent's successor to pay tax on that income which is called "IRD" for short.

The reason the Code contains the IRD doctrine, is that post-death *receipts* are not income to a decedent because § 443(a) closes the decedent's tax year on the date of his or her death. This means that the decedent doesn't pay tax on post-death income. Recall that inheritances aren't income to decedents' successors because § 102 says they're not. So, were it not for the IRD doctrine, no tax at all would be paid on the post-death receipts of cash-basis taxpayers. To be certain that post-death receipts do not escape taxation, the Code contains the following "IRD" section:

§ 691. Recipients of income in respect of decedents

(a) Inclusion in gross income

(1) General rule. The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death . . . shall be included in the gross income, for the taxable year *when received*, of:

. . .
(B) the person who, by reason of the death of the decedent, acquires the right to receive the amount. . . .

Notice that § 691(a)(1) says that the decedent's successor must report IRD "for the taxable year *when received*." Suppose that the decedent's successor inherits a right to receive income in respect of a decedent, but sells that right to someone else *before* the income is collected? You'll recall (from the Survey course) that in general, those who inherit property from a decedent get a stepped-up basis, so that their basis is the inherited property's fair market value as of the date of the decedent's death. Here is the Code section that does this:

§ 1014. Basis of property acquired from a decedent

(a) In general. Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent . . . shall . . . be -

(1) the fair market value of the property at the date of the decedent's death. . . .

(b) Property acquired from the decedent. For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

(1) Property acquired by bequest, devise, or inheritance . . . from the decedent. . . .

Does § 1014 mean that if a successor inherits a right to collect, say, \$25,000 in income earned (but not collected) by the decedent, the successor has a \$25,000 basis in that right? *If so*, that would mean that if the successor sold the right for \$25,000 – instead of collecting the income, which would have been taxable to the successor under § 691(a) – the successor would have no gain and thus no taxable income. But, as you must have guessed, the answer is “no”; the successor’s sale of the right will result \$25,000 in income. It will, because the basis of property which consists of a right to collect IRD is *not* stepped up. And if the property would have been ordinary income if received by the decedent, it remains ordinary income in the hands of the decedent’s successor. Here are the Code sections that so provide:

§ 1014. Basis of property acquired from a decedent

- ...
- (c) Property representing income in respect of a decedent. This section [i.e., §1014(a) providing for a step-up in basis] shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

§ 691. Recipients of income in respect of decedents

- (a) Inclusion in gross income

- ...
- (3) Character of income determined by reference to decedent. The right, described in paragraph (1), to receive an amount shall be treated, in the hands of . . . any person who acquired such right by reason of the death of the decedent . . . as if it had been acquired by . . . such person in the transaction in which the right to receive the income was originally derived and the amount includible in gross income under paragraph (1) . . . shall be considered in the hands of . . . such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount.

One last point, and we’re done with IRD: suppose that the successor doesn’t inherit a right to collect income earned by the decedent, but instead inherits an interest in a partnership that itself owns a right to collect income that was earned when the decedent was alive, and that would have been allocated to the decedent if he or she had lived? How, in other words, does the IRD doctrine work with inherited partnership interests? The Code answers that question this way:

§ 691. Recipients of income in respect of decedents

- ...
- (e) Cross reference. For application of this section [i.e., the section that requires successors to include IRD in their own incomes] to income in respect of a deceased partner, see section 753.

§ 753. Partner receiving income in respect of decedent

The amount includible in the gross income of a successor in interest of a deceased partner under section 736(a) shall be considered income in respect of a decedent under section 691.

Section 736(a) payments (you'll recall from Study Guide 18) are payments that:

- are *not* in exchange for a partner's interest in partnership *property* [§ 736(b)(1)]
or
- are payments to a general partner in a personal *service* partnership [§ 736(b)(3)] that
 - are in exchange for the partner's interest in the partnership's unrealized receivables [§736(b)(2)(A)]
or
 - are in exchange for the partner's interest in the partnership's goodwill *if* the partnership agreement did *not require* payment for goodwill [§736(b)(2)(B)].

So, if we put all this together, we get: A deceased partner's successor gets a step-up in the basis of the inherited partnership interest to its fair market value on the date of the partner's death, *except* that basis is not stepped-up for the portion of the value of the interest that is attributable to payments that will be made for something other than an interest in partnership property or for unrealized receivables or for goodwill (if the partnership agreement didn't require payment for goodwill).

Differences in Outside and Inside Bases

While a stepped-up basis is not available for IRD items (unrealized receivables, etc.), a deceased partner's successor does get a stepped-up basis for the rest of his or her interest in the partnership (to its fair market value). The successor's stepped-up basis is his or her "outside" basis in the partnership interest. And it is likely that there will be a difference between the successor's outside basis and the partnership's inside basis in the successor's share of the partnership's assets.

This difference matters because if the partnership later sells some of its assets, some of the gain will be allocated and taxable to the successor partner, even though the fair market value of the inherited partnership interest was part of the taxable estate of the deceased partner. In other words, it's possible that the difference between the partnership's basis in the successor's share of the partnership's assets and the fair market value of those assets will be taxed twice: first, as part of the taxable estate of the deceased partner; and then, as taxable income to the successor partner, when the partnership sells those assets for their fair market value.

The remedy: a § 754 election – the same kind of election we looked at earlier in connection with

- distributions of property to partners in Study Guide 11,
- the purchase of a partnership interest in Study Guide 17, and
- liquidation of a partner's interest in Study Guide 18.

And we'll be seeing § 754 elections again, when we get to liquidating an entire partnership in Study Guide 25.

Questions re Transferring the Interest of a Deceased Partner

1. The partnership formed by Anne, Beth, Carl and Doug is a cash-basis taxpayer with a tax year ending December 31st. The partnership had income of \$100,000 for all of last year: it earned \$40,000 from January through June, and \$60,000 from July through December. Beth passed away on June 30th, leaving her 25% interest in the partnership to her successor Sam who remained a partner for the balance of the year. What were the income tax consequences to Beth and Sam?
 - a. Beth's final tax return will report \$10,000 in income (her 25% share of the partnership's \$40,000 in income earned to the date of her death). Sam will report \$15,000 in income (his 25% share of the partnership's \$60,000 in income earned from July through December).
 - b. Beth's final tax return will report no income, and Sam will report \$25,000 in income, because the share of the partnership's \$100,000 that was allocated to the interest owned by Beth and inherited by Sam was allocated at the end of the partnership's tax year, by which time Sam was a partner, not Beth.
 - c. Beth's final tax return will report \$25,000 in income (her 25% share of the partnership's \$100,000 in income for its taxable year). Sam will report no income for the year of Beth's death.

2. The partnership formed by Anne, Beth, Carl and Doug is a cash-basis taxpayer with a tax year ending December 31st. Their partnership agreement says nothing at all about what happens if a partner dies. Beth passed away on June 30th, and her partnership interest passed to Sam, her successor. Sam, however, didn't want to be a partner; he wanted money. So in a deal Sam made after Beth's death, he sold the interest he had inherited to Anne, Carl and Doug for a total of \$150,000 (\$50,000 from each). On the date of Beth's death, her 25% interest in the partnership had a fair market value of \$150,000, but her basis in her partnership interest was just \$50,000 (because she obtained her interest in exchange for real estate which she had earlier purchased for \$50,000, though the real estate had a fair market value of \$100,000 when she contributed it to the partnership). The partnership had earned and collected \$40,000 through the date of Beth's death, and it also had unrealized receivables of \$20,000 on that date, and those receivables were still unrealized (i.e., not yet collected) as of the date that Sam sold the partnership interest to Anne, Carl and Doug. Beth's share of the unrealized receivables was \$5,000 (i.e., 25% of \$20,000), so the balance of her partnership interest was valued at \$145,000. What were the income tax consequences to Beth and Sam?
 - a. Beth's final tax return will report \$10,000 in partnership income through the date of her death (her share of the partnership's \$40,000 in income to that date), plus \$100,000 of gain on the sale of her partnership interest to Anne, Carl and Doug. Sam will not have to pay tax on the unrealized receivables, because he sold his partnership interest before they were received. And Sam will not have to pay tax on the \$150,000 he received from the other partners for the interest he had inherited, because his basis for the interest was stepped-up to \$150,000, so he didn't realize any gain.
 - b. Beth's final tax return will report \$10,000 in partnership income through the date of her death (her share of the partnership's \$40,000 in income to that date), but no gain on the sale of what had been her partnership interest to Anne, Carl and

Doug, because by the time they bought it, Beth was no longer its owner. Instead, Sam will have \$100,000 in gain from the sale of what, by then, was his interest in the partnership – \$100,000 because his basis in the partnership interest was the same as Beth’s (i.e., \$50,000).

- c. Beth’s final tax return will report \$10,000 in partnership income through the date of her death, because that’s her share of the partnership’s \$40,000 in income to that date. Her final return will not report what appears to be the \$100,000 gain from the sale of her partnership interest to Anne, Carl and Doug, because by the time it was sold, Beth neither owned it nor sold it – Sam did. Sam will report \$5,000 in ordinary income from the sale of the partnership interest he inherited from Beth – *not* a \$100,000 capital gain, even though that is the difference between Beth’s \$50,000 basis and the \$150,000 Sam realized; and *not* \$0 even though Sam was entitled to a stepped-up basis in the partnership interest he inherited. Sam has \$5,000 in ordinary income, because even though he gets a stepped-up basis for most of what he inherited (Code 1014(a) & (b)), he did *not* get a stepped-up basis for the \$5,000 portion of his inheritance that represented Income in Respect of a Decedent (Code 1014(c)). What’s more, that \$5,000 is ordinary income to him – not a capital gain – because that \$5,000 would have been ordinary income to Beth if she had lived to receive it, so its ordinary income to him too (Code 691(a)(3)).
3. Assume the same facts as Question 2, with these this exception: Sam sold the partnership interest to Shelley for \$150,000. Is your answer to this question the same as or different from your answer to Question 2?
 - a. It’s the same. Nothing of tax consequence has changed, insofar as Sam is concerned. In other words, it doesn’t matter that in Question 2, Sam sold his interest to buyers who already were partners, while in this Question 3, he sold to someone who was not already a partner. What matters is that Sam inherited Beth’s partnership interest, and then he made a deal to sell it.
 - b. It’s different. The tax consequences of this transaction are nothing like the consequences of the transaction in Question 2. (What is your answer to this question?)
 4. The partnership formed by Anne, Beth, Carl and Doug is a: *general* (not limited) partnership, in which capital is *not* a material income-producing factor, and a cash-basis taxpayer with a tax year ending December 31st. The partnership agreement signed by Anne, Beth, Carl and Doug when they first formed the partnership contains a Liquidation Clause that requires the partnership to liquidate the interest of any partner who dies, immediately after the deceased partner’s death, for the fair market value of that interest as of the partner’s date of death. Beth’s basis in her 25% interest in the partnership was \$50,000, because she obtained her interest in exchange for real estate which she had earlier purchased for \$50,000, though the real estate had a fair market value of \$100,000 when she contributed it to the partnership. Beth passed away on June 30th, on which date her 25% interest had a fair market value of \$150,000. The partnership liquidated Beth’s interest by paying her successor Sam \$150,000. The partnership had earned \$40,000 through the date of Beth’s death, Beth’s share of which was allocated and distributed to her while she was alive. The partnership also had unrealized receivables of \$20,000 on the date Beth died. Because the partnership liquidated Beth’s interest immediately after her death, those receivables weren’t yet collected when the liquidation took place; but the existence of those receivables was taken into account in determining the fair market value of Beth’s interest on the date of her death. If Beth’s

share of the unrealized receivables was valued at \$5,000, and the balance of Beth's interest was valued at \$145,000, what were the income tax consequences to Beth and Sam?

- a. Beth's final tax return will report \$10,000 in partnership income through the date of her death (her share of the partnership's \$40,000 in income to that date), plus \$100,000 of gain from the liquidation of her interest. Sam will not have to pay tax on the unrealized receivables, because he never became a partner. And Sam will not have to pay tax on the \$150,000 he received from the partnership, because that was simply money he inherited from Beth.
 - b. Beth's final tax return will report \$10,000 in partnership income through the date of her death (her share of the partnership's \$40,000 in income to that date), plus \$150,000 from the liquidation of her partnership interest. Sam will not have to pay tax on the unrealized receivables, because he never became a partner. And Sam will not have to pay tax on the \$150,000 he received from the partnership, because that was simply money he inherited from Beth.
 - c. Beth's final tax return will report \$10,000 in partnership income through the date of her death (her share of the partnership's \$40,000 in income to that date), plus \$95,000 in capital gains representing the amount by which \$145,000 of the money she received exceeded her \$50,000 basis in the partnership, plus \$5,000 in ordinary income representing her share of the unrealized receivables. Sam will not have to pay tax on the unrealized receivables, because he never became a partner. And Sam will not have to pay tax on the \$150,000 he received from the partnership, because that was simply money he inherited from Beth.
5. Assume the same facts as Question 4, with these two exceptions: (i) The partnership agreement did *not* contain a Liquidation clause; (ii) however, immediately after Beth's death, the partnership offered to liquidate the interest Sam had inherited from Beth, Sam agreed, and the partnership paid Sam \$150,000 to liquidate his interest. Is your answer to this question the same as or different from your answer to Question 4?
- a. It's the same. Nothing of tax consequence has changed, insofar as Sam is concerned.
 - b. It's different, because in Question 4, Beth was the owner of the interest being liquidated and Sam was simply inheriting the money paid in liquidation of her interest. In this question, Sam inherited Beth's partnership interest, and thus is the owner of the interest being liquidated. Beth's final tax return still will report \$10,000 in partnership income through the date of her death (her share of the partnership's \$40,000 in income to that date). But in this question, it'll be Sam who has to report and pay taxes on the consequences of the liquidation. He will have no capital gains (because \$145,000 of the money he received was equal to his \$145,000 stepped-up basis in the partnership), but he will have \$5,000 in ordinary income representing his share of the unrealized receivables.
6. Would the answers to questions 4 and 5 change, if the partnership was a *limited* partnership and/or capital was a material income-producing factor?
- a. The answers to both questions would be the same.
 - b. The answers would be a little different. The answer to Question 4 would be that Beth (actually, her estate) would have \$100,000 in capital gains (rather than \$95,000) but no ordinary income (rather than \$5,000). And the answer to Question 5 would be that Sam would have no capital gains and no ordinary income either. (The rest of both answers would remain the same.) The reason

that it matters whether Beth was a limited or general partner, and whether capital was a material income-producing factor for the partnership, is that the rule making unrealized receivables taxable to a retiring partner or deceased partner's successor applies only if the retiring or deceased partner was a general partner and only if capital was a material income-producing factor.

7. The partnership formed by Anne, Beth, Carl and Doug is a cash-basis taxpayer with a tax year ending December 31st. The partnership agreement signed by Anne, Beth, Carl and Doug when they first formed the partnership contains a Buy-Sell Clause that requires the surviving partners to buy the interest of any partner who dies, immediately after the deceased partner's death, for the fair market value of that interest as of the partner's date of death. Beth's basis in her 25% interest in the partnership was \$50,000, because she obtained her interest in exchange for real estate which she had earlier purchased for \$50,000, though the real estate had a fair market value of \$100,000 when she contributed it to the partnership. Beth passed away on June 30th, on which date her 25% interest had a fair market value of \$150,000. Anne, Carl and Doug purchased Beth's interest by paying her estate \$50,000 each for a total of \$150,000. Sam was Beth's sole successor, and the estate distributed the \$150,000 to him. The partnership had earned and collected \$40,000 through the date of Beth's death. The partnership also had unrealized receivables of \$20,000 on the date Beth died. Because Anne, Carl and Doug purchased Beth's interest immediately after her death, those receivables weren't yet collected when the purchase took place; but the existence of those receivables was taken into account in determining the fair market value of Beth's interest on the date of her death. Beth's share of the unrealized receivables was \$5,000, and the balance of Beth's interest was valued at \$145,000. What were the income tax consequences to Beth and Sam?
- Beth's final tax return will report \$10,000 in partnership income through the date of her death, because that is her share of the partnership's \$40,000 in income to that date. Her estate will have \$95,000 in capital gains from the sale of her interest to Anne, Carl and Doug, and \$5,000 in ordinary income. The \$95,000 in capital gains is the amount by which \$145,000 of the money her estate received exceeded her \$50,000 basis in the partnership. The \$5,000 in ordinary income is her share of the unrealized receivables.
 - Sam will not have to pay tax on the \$150,000 he received from the estate, because that was simply money he inherited from Beth, and inheritances are not taxable income.
 - Both "a" and "b".
 - None of the above. (What is your answer to this question?)

Recap:

So now you see the difference between (i) a successor's *sale* of an inherited partnership interest (Questions 2 and 3) and (ii) the *sale* of a partnership interest by the estate of a deceased partner pursuant to a pre-death Buy-Sell agreement (Question 7). I emphasized the word "sale" in the preceding sentence, because it's necessary to consider what the tax consequences are of the *liquidation* of a deceased partner's interest. Recall that a "liquidation" is the acquisition of a partnership interest by the *partnership itself* (SG 18.1), rather than by its individual partners. Just like "sales," liquidations can be agreed to (i) among partners before any of them dies, or (ii) between the successor of a deceased partner and the partnership, after a partner dies. (Questions 4 and 5 covered these two possibilities.)

Study Guide 20

TRANSFERRING A BUSINESS

Transferring a Shareholder's Stock

- Selling a Shareholder's Stock
 - Redeeming a Shareholder's Stock (Part 1)
-

Transferring a Shareholder's Stock

Shareholders may "transfer" stock they own in a corporation in either of two ways:

- by selling it to someone else, or
- by selling it back to the corporation in a transaction called a "stock redemption."

Selling a Shareholder's Stock

The tax consequences of selling stock to someone else are so straight-forward that the Schwarz & Lathrope book says nothing about them, thinking (I presume) that you already know all about this from the Survey course. I think so too, but let's refresh your recollection, so you'll be able to compare the tax consequences of "selling" with those of being "redeemed."

Amount of Gain or Loss

You'll recall that the amount of a taxpayer's gain or loss from the sale of stock is simply whatever amount the taxpayer receives for his or her shares, less whatever he or she paid for them (though it takes the Code three steps to get there):

§ 1001. Determination of amount of and recognition of gain or loss

- (a) Computation of gain or loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

§ 1011. Adjusted basis for determining gain or loss

- (a) General rule.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 . . .). . . .

§ 1012. Basis of property—cost

- The basis of property shall be the cost of such property. . . .

Gain as Taxable Income

You'll also recall that, as a *general* rule, gains from the sale of stock are taxable income to the selling shareholder:

§ 61. Gross income defined

- (a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . .
- (3) Gains derived from dealings in property. . . .

I've characterized § 61 as the "general" rule – rather than as the absolute rule – because there's a special rule that applies to the sale of stock in a "qualified small business." We looked at this special rule back in Study Guide 5 when we were considering the tax benefits of using debt (rather than stock) to capitalize a corporation. The special rule for qualified small business stock was offered (in Study Guide 5) as a counterweight to the tax advantages of debt, because the special rule is a tremendous tax advantage given to the owners of stock in qualified small businesses. Here again is that special rule:

§ 1202. Partial exclusion for gain from certain small business stock

- (a) Exclusion
 - (1) In general. In the case of a taxpayer other than a corporation, gross income shall not include 50 percent* of any gain from the sale or exchange of qualified small business stock held for more than 5 years.
 -
- (c) Qualified small business stock. For purposes of this section -
 - (1) In general. Except as otherwise provided in this section, the term "qualified small business stock" means any stock in a C corporation which is originally issued after the date of the enactment of the Revenue Reconciliation Act of 1993, if -
 - (A) as of the date of issuance, such corporation is a qualified small business, and
 - (B) . . . such stock is acquired by the taxpayer at its original issue . . .
 - (i) in exchange for money or other property (not including stock), or
 - (ii) as compensation for services provided to such corporation. . . .
- (d) Qualified small business. For purposes of this section -
 - (1) In general. The term "qualified small business" means any domestic corporation which is a C corporation if -
 - (A) the aggregate gross assets of such corporation . . . before the issuance did not exceed \$50,000,000, [and]
 - (B) the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) do not exceed \$50,000,000. . . .

* Increased by the Recovery Act of 2009 to a 75% exclusion for stock acquired after Feb 17, 2009 and *before* Jan 1, 2011; and increased further by the Small Business Act of 2010 to a 100% exclusion for stock acquired after Sep 27, 2010 and *before* Jan 1, 2011.

Finally, you'll recall that gains from the sale of stock are capital gains, taxed at favorable (i.e., lower) long-term rates if the shareholder sells the stock after owning it for more than one year, or at less favorable short-term rates if the shareholder sells the stock after owning it for a year or less.

Tax Treatment of Losses on the Sale of Stock

Read (in Schwarz & Lathrope)

Pages 161 - 165

The Code recognizes that taxpayers sometimes lose money when they sell stock, and it permits them to deduct those losses:

§ 165. Losses

- (a) General rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
- (b) Amount of deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.
- (c) Limitation on losses of individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to [a few things, including]
 - . . .
 - (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business. . . .

However, you'll recall that losses from the sale of stock may be deducted in full only if and to the extent the taxpayer has capital gains that same year, from which to deduct his or her stock losses. If the taxpayer doesn't have gains, or doesn't have enough gains to fully offset his or her losses, the taxpayer will be able to deduct only a portion of those losses (in the year in which they were incurred, though the non-deductible balance may be carried forward and used in later years). Here's the Code section that does that:

§ 1211. Limitation on capital losses

- . . .
- (b) Other taxpayers. In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of -
 - (1) \$3,000 (\$1,500 in the case of a married individual filing a separate return), or
 - (2) the excess of such losses over such gains.

There is, however, an exception to § 1211's \$3,000 per year cap on deductions against ordinary income – an exception that is extremely important to shareholders in most small businesses. For taxpayers who qualify and need it, the exception allows them to deduct as much as \$100,000 in stock losses from their ordinary income. Here's the Code section that makes this benefit available:

§ 1244. Losses on small business stock

- (a) General rule. . . . [A] loss on section 1244 stock . . . which would (but for this section) be treated as a loss from the sale or exchange of a capital asset shall, to the extent provided in this section, be treated as an ordinary loss.
- (b) Maximum amount for any taxable year. For any taxable year the aggregate amount treated by the taxpayer by reason of this section as an ordinary loss shall not exceed -
 - (1) \$50,000, or
 - (2) \$100,000, in the case of a husband and wife filing a joint return. . . .
- (c) Section 1244 stock defined
 - (1) In general. For purposes of this section, the term "section 1244 stock" means stock in a domestic corporation if -
 - (A) at the time such stock is issued, such corporation was a small business corporation,
 - (B) such stock was issued by such corporation for money or other property (other than stock and securities), and
 - (C) such corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.
 - (2) Rules for application of paragraph (1)(C)
 - (A) Period taken into account with respect to new corporations. For purposes of paragraph (1)(C), if the corporation has not been in existence for 5 taxable years ending before the date the loss on the stock was sustained, there shall be substituted for such 5-year period -
 - (i) the period of the corporation's taxable years ending before such date, or
 - (ii) if the corporation has not been in existence for 1 taxable year ending before such date, the period such corporation has been in existence before such date.
 - (3) Small business corporation defined
 - (A) In general. For purposes of this section, a corporation shall be treated as a small business corporation if the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed \$1,000,000. . . .

Reg. § 1.1244(c)-1

- (d) Issued for money or other property. (1) The stock must be issued to the taxpayer for money or other property transferred by the taxpayer to the corporation. . . . Stock issued for services rendered or to be rendered to, or for the benefit of, the issuing corporation does not qualify as section 1244 stock. Stock issued in consideration for cancellation of indebtedness of the corporation shall be considered issued in exchange for money or other property unless such indebtedness . . . arises out of the performance of personal services.

One last point about losses: if a shareholder sells his or her stock to a related party, the loss is not deductible at all. Here is some of the Code section that does that:

§ 267. Losses . . . with respect to transactions between related taxpayers

(a) In general

(1) Deduction for losses disallowed. No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). . . .

(b) Relationships. The persons referred to in subsection (a) are:

(1) Members of a family . . . ;

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual. . . .

Questions re Selling a Shareholder's Stock

Note: You'll recall that in Study Guide 3, we covered (some of) the tax consequences of capitalizing a corporation with debt, rather than with equity – i.e., borrowing money by “selling” promissory notes, rather than selling stock. Now, in this Study Guide 20, we're covering the tax consequences of a shareholder's sale of *stock*. The tax treatment of a shareholder's sale of stock may be better (from the taxpayer's point of view) than the tax treatment of a lender's sale of a promissory note. That is why some of the following questions ask about the consequences of selling a note, rather than stock.

1. Suppose that when Anne lends the corporation \$50,000, the note entitles her to interest at 10%, and that the corporation is profitable and thus makes regular payments to her of principal and interest. Suppose also that when the balance due on the note is \$40,000 (because some of her loan has been repaid), then prevailing interest rates in the marketplace (for loans similar to the one she made to the corporation) have dropped significantly. That would make her note worth more than \$40,000. If Anne were to sell her note to someone else, or sell it back to the corporation, for \$45,000, how would her \$5,000 gain (sale price over the \$40,000 balance) be taxed to her?
 - a. At ordinary income tax rates.
 - b. At capital gain rates.
 - c. Half (\$2,500) would be taxed at capital gain rates, but half wouldn't be taxed at all.
2. If, at the same time Anne sold her note, she also sold her stock for \$55,000 (\$5,000 more than she paid for it), how would the \$5,000 gain on her stock be taxed to her?
 - a. At ordinary income tax rates, if she held the stock for less than a year.
 - b. At capital gain rates, if she held the stock for one to five years.
 - c. Half (\$2,500) would be taxed at capital gain rates, but half wouldn't be taxed at all, if she held the stock for more than five years.
 - d. All of the above.

3. Suppose that when Anne lends the corporation \$50,000, the note entitles her to interest at 5%, and that the corporation is profitable and thus makes regular payments to her of principal and interest. Suppose also that when the balance due on the note is \$40,000 (because some of her loan has been repaid), then prevailing interest rates in the marketplace (for loans similar to the one she made to the corporation) have increased substantially. That would make her note worth less than \$40,000. If Anne were to sell her note to someone else, or sell it back to the corporation, for \$35,000, what would the tax consequences be to her of the \$5,000 loss (\$40,000 balance less sale price)?
 - a. The entire \$5,000 loss would be an ordinary loss, and Anne could deduct it against whatever income she had from other sources, the year she sold the note.
 - b. It would be a capital loss, deductible against her capital gains (if any) in full; but if she didn't have \$5,000 in capital gains that year, only \$3,000 would be deductible against her ordinary income the first year, and the remaining \$2,000 loss couldn't be deducted until the next year.
4. If, at the same time Anne sold her note, she also sold her stock for \$45,000 (\$5,000 less than she paid for it), what would the tax consequences be to her of the \$5,000 loss?
 - a. The entire \$5,000 loss would be an ordinary loss, and Anne could deduct it against whatever income she had from other sources, the year she sold the stock.
 - b. It would be a capital loss, deductible against her capital gains (if any) in full; but if she didn't have \$5,000 in capital gains that year, only \$3,000 would be deductible against her ordinary income the first year, and the remaining \$2,000 loss couldn't be deducted until the next year.
5. Suppose that at the same time Anne sold her stock for \$55,000, Beth, Carl and Doug sold their stock too, for the same amount: \$55,000 each. How would their gains be taxed to them, *if* they held their stock for more than five years before selling it?
 - a. At ordinary income tax rates.
 - b. At capital gain rates.
 - c. All three would pay tax on half their gains at capital gain rates, but wouldn't have to pay tax on half at all.
 - d. Beth and Carl would pay tax on half their gains at capital gain rates, but they wouldn't have to pay tax on half at all. Doug would have to pay tax on his entire gain at capital gain rates.

6. Suppose that at the same time Anne sold her stock for \$45,000, Beth, Carl and Doug sold their stock too, for the same amount: \$45,000. What would the tax consequences to them be of their \$5,000 losses?
- The entire \$5,000 loss would be an ordinary loss for each of them, and all three could deduct it against whatever income they had from other sources, the year they sold the stock.
 - The entire \$5,000 loss would be an ordinary loss for Beth and Carl, and the two of them could deduct it against whatever income they had from other sources, the year they sold the stock. But it would be a capital loss for Doug, deductible against his capital gains (if any) in full; but if he didn't have \$5,000 in capital gains that year, only \$3,000 would be deductible against his ordinary income the first year, and the remaining \$2,000 loss couldn't be deducted until the next year.
 - It would be a capital loss for all three of them, deductible against their capital gains (if any) in full; but if they didn't have \$5,000 in capital gains that year, only \$3,000 would be deductible against their ordinary income the first year, and the remaining \$2,000 loss couldn't be deducted until the next year.
7. After being in business for more than five years, Anne and Carl decide to sell all of their stock to Beth and Doug. They agree on a price of \$75,000 for Anne's stock and the same price for Carl's. Anne's basis in her stock was still \$100,000; and Carl's was still \$25,000. If Anne and Carl are *not related* to Beth or Doug, which of the following most accurately states the tax consequences to Anne and Carl?
- Neither will have taxable income, because they sold their stock to other shareholders in the same corporation, rather than to outsiders.
 - Both will have long-term taxable capital gains of \$75,000 each.
 - Anne will have a long-term capital loss of \$25,000; and Carl will have a long-term capital gain of \$50,000.
 - If the corporation has the same characteristics it had in earlier Study Guides, Anne will have an ordinary loss of \$25,000, and Carl will have a long-term capital gain of \$25,000.
8. If Anne and Carl were Beth and Doug's parents, would your answer to Question 1 remain the same?
- Yes. The answer to Question 1 would remain the same.
 - No. The answer to Question 1 would be different, because Anne wouldn't be able to deduct her loss and Carl wouldn't have to pay tax on his gain.
 - No. The answer to Question 1 would be different, because even though Carl would still have to pay tax on his gain, Anne wouldn't be able to deduct her loss.

Redeeming a Shareholder's Stock

The Code sections that deal with stock redemptions contain a blizzard of details, among which the main points may be difficult to see. It is, however, the main points that are important, so let's tease them out.

Begin with the Code's explanation of what constitutes a stock redemption:

§ 317. Other definitions

- (a) Property. For purposes of this part, the term "property" means money, securities, and any other property. . . .
- (b) Redemption of stock. For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

So far, so good. Section 317 is vulnerable to the quibble that it is constructed upside down; it gives us a perfectly logical and barely necessary definition of "property" *before* it tells us that a redemption is the acquisition by a corporation of its own stock in return for "property." But the section doesn't seem to present any comprehension problems. By itself, it doesn't even seem to require a chapter or Study Guide.

As you'll see, though, redemptions are of two types: those that are taxed like *dividends*, and those that are taxed like *sales or exchanges*. You know how dividends are taxed, from Study Guide 13. And you know how sales or exchanges are taxed from the first part of this Study Guide. As a result, you also know that dividends are taxed differently from sales or exchanges. Generally, taxes on the gains from sales or exchanges are less than taxes on dividends. (This is so today, even though dividends are now taxed at capital gains rates; and it was especially true when dividends were taxed at ordinary income rates.) So it won't surprise you to see that the Code goes to great lengths to distinguish redemptions that are taxed like dividends from those that are taxed like sales or exchanges. Here are the main points:

§ 302. Distributions in redemption of stock

- (a) *General rule.* If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.
- (b) *Redemptions treated as exchanges*
 - (1) Redemptions not equivalent to dividends. Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.
 - (2) Substantially disproportionate redemption of stock
 - (A) In general. Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.
 - . . .
 - (3) Termination of shareholder's interest. Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.
 - (4) Redemption from noncorporate shareholder in partial liquidation. Subsection (a) shall apply to a distribution if such distribution is -
 - (A) in redemption of stock held by a shareholder who is not a corporation, and
 - (B) in partial liquidation of the distributing corporation.
 - . . .
- (d) *Redemptions treated as distributions of property.* Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

§ 301. Distributions of property

(a) In general. Except as otherwise provided in this chapter, a distribution of property . . . made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

. . .
(c) Amount taxable. In the case of a distribution to which subsection (a) applies -

(1) Amount constituting dividend. That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

. . .
(d) Basis. The basis of property received in a distribution to which subsection (a) applies shall be the fair market value of such property.

§ 316. Dividend defined

(a) General rule. For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders - . . . out of its earnings and profits. . . .

Read Schwarz & Lathrope

Pages 189-190

Pages 194-208

I've edited the version of § 302 on the preceding page to eliminate much of its detail. Those details are well-described (in pretty readable English) in the Schwarz & Lathrope reading assignment. You may want to give particular attention to the pages 194-195 which explain what § 302(b)(2)(A) means when it refers to "a distribution [that] is substantially disproportionate." Otherwise, you should be able to answer the questions below, right from the language of the Code.

The portion of the reading assignment dealing with the tax consequences of the redemption (pages 204-208) restate what we've covered already in Study Guide 13, so if it looks familiar to you, don't be surprised, and if it doesn't, go back and look at Study Guide 13 again.

Questions re Redeeming a Shareholder's Stock

9. After being in business for more than five years, Anne and Carl decided to withdraw as shareholders. They and Beth and Doug decided that the corporation would redeem their stock. They agreed on a price of \$75,000 for Anne's stock and the same price for Doug's. Anne's basis in her stock was still \$100,000; and Carl's was still \$25,000. The corporation had no retained earnings (so the \$75,000 payments were not a dividend). Which of the following most accurately states the tax consequences to Anne and Carl?
- Neither will have taxable income, because the corporation had no retained earnings at the time of redemption.
 - Anne will have a long-term capital loss of \$25,000; and Carl will have a long-term capital gain of \$50,000.
 - If the corporation has the same characteristics it had in earlier Study Guides, Anne will have an ordinary loss of \$25,000, and Carl will have a long-term capital gain of \$25,000.
 - Carl will have a long-term capital gain of \$50,000; but Anne will not be able to deduct her loss, because her stock was acquired the corporation which is a related party.
10. Suppose that the corporation has been in existence for a few years, and that more than a year ago, Anne purchased all 1000 shares of Carl's stock from him for \$100,000 and all 1000 shares of Beth's stock from her for \$100,000. That would have given her 3000 shares or 75% of the corporation's stock, in which she'd have a basis of \$300,000. If the corporation then redeemed all 3000 shares of Anne's stock for \$250,000, and the corporation had no retained earnings at the time it did so, what will the tax consequences to her be?
- She will have no taxable income, because the corporation had no retained earnings at the time of the redemption.
 - Anne will have a loss but will not be able to deduct it, because her stock was acquired by the corporation which is a related party.
 - Anne will have a long-term capital loss of \$50,000.
 - If the corporation has the same characteristics it had in earlier Study Guides, Anne will have an ordinary loss of \$50,000.

11. Suppose that the corporation has been in existence for a few years, and that more than a year ago, Anne purchased all 1000 shares of Carl's stock from him for \$100,000 and all 1000 shares of Beth's stock from her for \$100,000. That would have given her 3000 shares or 75% of the corporation's stock, in which she'd have a basis of \$300,000 (i.e., \$100/share). If the corporation then redeemed 500 shares of Anne's stock for \$75,000 (i.e., \$150/share), and the corporation had no retained earnings at the time it did so, what will the tax consequences to her be?
- She will have no taxable income, because the corporation had no retained earnings at the time of the redemption.
 - She will have \$75,000 in capital gains (i.e., \$150/share), because the corporation had no retained earnings at the time of the redemption.
 - She will have \$25,000 in capital gains (i.e., \$50/share), because the corporation had no retained earnings at the time of the redemption.
 - She will have \$25,000 in ordinary income (i.e., \$50/share), because her stock was acquired by the corporation which is a related party.
12. Suppose the facts are the same as they were in Question 11, with this one exception: at the time the corporation redeemed Anne's stock, it had retained earnings of \$75,000.
- She will have no taxable income, because the corporation had no retained earnings at the time of the redemption.
 - She will have \$75,000 in income taxed at capital gains rates (i.e., \$150/share), because the corporation had \$75,000 in retained earnings at the time of the redemption.
 - She will have \$75,000 in ordinary income (i.e., \$150/share), because her stock was acquired by the corporation which is a related party.
 - She will have \$25,000 in capital gains (i.e., \$50/share), because the corporation had retained earnings at the time of the redemption.
13. Suppose the facts are the same as they were in Question 12, with this one exception: at the time the corporation redeemed Anne's stock, it had retained earnings of \$15,000. In other words, the corporation has enough earnings and profits to cover \$15,000 of the payment to Anne, but not the remaining \$60,000 (out of a total redemption payment of \$75,000). The tax consequences to her would be:
- The first \$15,000 would cover the redemption of 100 shares (at \$150/share) and would be treated (and taxed) as a dividend. That would leave 400 shares, in which Anne would have a basis of \$100/share (\$40,000 total).
 - Answer "a" is correct, as far as it goes. Also, the next \$40,000 would reduce Anne's basis in her remaining 400 shares to \$0. That \$40,000 would not be income to her and would not be taxed.
 - Answer "b" is correct, as far as it goes. Also, there's still \$20,000 left (\$75,000 total payment - \$15,000 from earnings and profits - \$40,000 to reduce basis to nothing). That \$20,000 will be taxed as a gain from a sale of her stock, i.e., taxed at capital gains rates.
 - All of the above.

Study Guide 21

TRANSFERRING A BUSINESS

Transferring a Shareholder's Stock

Redeeming a Shareholder's Stock (Part 2)

Redeeming a Shareholder's Stock

Section 302 of the Code (covered in Study Guide 20) states the "general rule" concerning:

- when a stock redemption will be treated like a *dividend*, which means the entire amount of the payment will be taxed to the shareholder whose stock was redeemed (though under current law, taxed at capital gains, rather than ordinary income, rates), and
- when a stock redemption will be treated like a *sale or exchange* of the redeemed stock, which means that only the gain (the amount by which the payment exceeds the shareholder's basis in the redeemed stock) will be taxed (at capital gains rates).

Now we will look at some special cases, for which there are other Code sections, Regulations, judicial decisions and Revenue Rulings. These special cases involve circumstances that confront many taxpayers; and the rules are designed to reduce the tax burden on some of them.

Redemptions to Pay Death Taxes

Read (in Schwarz & Lathrope)

Pages 215 (beginning at F) - 217

If a deceased shareholder's total estate exceeds a certain amount, the estate may have to pay an estate tax – referred to by some (including Professors Schwarz and Lathrope) as a "death" tax. The amount that is entirely exempt from estate tax has increased each year from 2002 to 2009; but in 2010 there was be no estate tax at all; and in 2011 it will increase to what it was in 2002 (unless Congress amends the law). Here are figures:

For deaths occurring in	the estate tax was or will be this percent	of the amount by which the fair market value of the estate's assets <i>exceeds</i>
2002	41% - 50%	\$1,000,000
2003	41% - 49%	\$1,000,000
2004	45% - 48%	\$1,500,000
2005	45% - 47%	\$1,500,000
2006	46%	\$2,000,000
2007	45%	\$2,000,000
2008	45%	\$2,000,000
2009	45%	\$3,500,000
2010	0%	-
2011	41% - 60%	\$1,000,000

You can see that for shareholders who died in 2010, no redemptions will be necessary to enable their estates to pay estate tax, because no estate tax will be owed, no matter how large an estate a decedent leaves behind (unless the law is amended). But for 2009 and again in 2011 (and beyond), the estate of a deceased shareholder may have to pay estate tax. One source of cash to pay those taxes is stock owned by the decedent, the fair market value of which will be included in the estate.

For this and other reasons, shareholder agreements sometimes require a corporation to redeem a deceased shareholder's stock. You already know that:

- *if* the redemption is treated like a *sale or exchange*, there will be *income* tax on the payment received from the redemption only if and to the extent the payment exceeds the decedent's basis in the redeemed stock; *but*
- *if* the redemption is treated like a *dividend*, there will be *income* tax on the entire amount of the redemption payment; and the redemption *will* be treated like a dividend (you'll recall from Study Guide 13) if the corporation has earnings and profits to cover the payment.

So, if a corporation has earnings and profits, there will be more *income* tax on the stock redemption payment than there will be *if*

- the corporation does *not* have earnings and profits, *or*
- the redemption is treated *like* a sale or exchange *even though* the corporation *does* have earnings and profits.

It's this last point – treatment “like a sale or exchange even though” (etc.) – that is accomplished by the following Code section:

§ 303. Distributions in redemption of stock to pay death taxes

(a) In general. *A distribution* of property to a shareholder by a corporation *in redemption* of part or all of the stock of such corporation which (for Federal estate tax purposes) is included in determining the gross estate of a decedent, to the extent that the amount of such distribution does not exceed the sum of -

- (1) the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death, and
- (2) the amount of funeral and administration expenses allowable as deductions to the estate . . . ,

shall be treated as a distribution in full payment in exchange for the stock so redeemed.

[Emphasis added.]

If we ignore the fact that it's necessary to die in order to get the benefit of § 303(a), the section offers some shareholders a nice tax savings. The savings were even nicer, back when dividends were taxed at ordinary income tax rates but gains on sales were taxed at capital gains rates, and back when the amount that was exempt from estate tax was much less than \$3.5 million. (In 2001, the exempt amount was only \$675,000, so anyone with an estate greater than that – e.g., many of those who owned homes in Los Angeles and probably most of those who owned apartments in Manhattan – had to pay estate tax.) Since the savings offered by § 303(a) were so nice, Congress felt it had to do something to make sure that those savings couldn't be claimed by the successors of every dead shareholder in the land. Congress did so by enacting some “limitations.”

As you noticed (I hope), one of the limitations is built into § 303(a) itself: a redemption payment will be treated as a payment in exchange for the redeemed stock only up to the amount of the estate taxes and funeral and administration expenses that must be paid. Some additional limitations are found in § 303(b):

§ 303. Distributions in redemption of stock to pay death taxes

- ...
- (b) Limitations on application of subsection (a)
- (1) Period of distribution. Subsection (a) shall apply only to amounts distributed after the death of the decedent and [within defined periods of time thereafter].
- (2) Relationship of stock to decedent's estate.
- (A) In general. Subsection (a) shall apply to a distribution by a corporation only if the value (for Federal estate tax purposes) of all of the stock of such corporation which is included in determining the value of the decedent's gross estate exceeds 35 percent of the [net value of the estate]. . . .
- ...
- (3) Relationship of shareholder to estate tax. Subsection (a) shall apply to a distribution by a corporation only to the extent that the interest of the shareholder is reduced . . . by any payment of an amount described in paragraph (1) or (2) of subsection (a).

So, in plain English, a redemption payment made to the successor of a dead shareholder will be taxed like a sale or exchange of the redeemed stock:

- only up to the amount of the estate taxes and funeral and administration expenses that must be paid, and then,
- only if a big part of the deceased shareholder's estate (35% or more) is tied up in the stock of the corporation that redeems it, and
- only if the inheritance of the shareholder's successor gets reduced in size by estate taxes or funeral or administration expenses.

This last point – which comes from § 303(b)(3) – is not apparent, on the face of that paragraph. In fact, the face of that section is more than a little misleading, because “the shareholder” referred to in § 303(b)(3) is *not* the deceased shareholder or his or her estate. Instead, that “shareholder” is someone – such as the deceased shareholder's spouse or child – who inherits the deceased shareholder's stock, and from whom the corporation redeems that stock. (This insight is buried in Reg. § 1.303-2(f).) Section 303(b)(3) limits the benefits of § 303(a) to those whose inheritance gets reduced in size by estate taxes or funeral or administration expenses. As a matter of estate planning – not tax law – the inheritance of one heir may be fixed in amount and isn't reduced by taxes or expenses, while the inheritance of another is not fixed and thus does get reduced by taxes and expenses. If you've taken the Wills & Trusts course, you understand how this works. For those who haven't taken that course, I'll explain, in class.

Keep in mind that these limits on reporting the gain from the redemption of a deceased shareholder's stock as though it were sold or exchanged become relevant *only if* the redemption would *not* have been treated as a sale or exchange under § 302 (which we covered in Study Guide 20). If the redemption of a deceased shareholder's stock qualifies for sale-or-exchange treatment under § 302(a), then that's how it'll be treated, even if the redemption doesn't qualify for sale-or-exchange treatment under § 303.

Question re Redemptions to Pay Death Taxes

1. The corporation formed by Anne, Beth, Carl and Doug had accumulated earnings and profits of \$600,000 at the end of last year. Earlier this year (2009), Beth passed away leaving her stock in the company to Sam, her only successor. Beth's estate is worth \$4 million, so there will be a \$225,000 estate tax to be paid, for which Sam will need cash. The fair market value of Beth's stock in the corporation on the date of her death was \$150,000, though her basis in the stock was just \$50,000. Suppose the corporation redeems all of Beth's stock from Sam for \$150,000. If the redemption is treated like a sale or exchange, Sam won't have any income tax at all from the redemption, because he'll get a step-up in the stock's basis (from Beth's \$50,000) to \$150,000 (its fair market value on the date of her death), under § 1014(a) [Study Guide 19, pg 4]. On the other hand, if the redemption is treated like a dividend, he'll have \$150,000 in taxable income on which he'll have to pay tax at 15% capital gains rates, which comes to \$22,500. That amount may not seem terribly dramatic to someone who's just inherited \$4 million. But, hey, \$22,500 is \$22,500, and if Sam wants to donate money to the federal government, he can, but he shouldn't do so as a result of inadequate legal advice. How will the redemption payment be treated, for income tax purposes?
 - a. The redemption payment is going to be treated as a taxable dividend under §303(b)(2)(A), because the \$150,000 value of the stock is much less than 35% of the total value of Beth's estate, and the corporation made the payment out of its accumulated earnings and profits.
 - b. The redemption payment is going to be treated as taxable dividend under §303(b)(3), because Sam's interest in Beth's estate will not be reduced by the estate tax, and the corporation made the payment out of its accumulated earnings and profits.
 - c. The redemption payment is going to be treated as a sale-or-exchange (so no tax will be paid) under § 302(b)(3), because the redemption is a complete redemption of all of Sam's stock in the corporation.
 - d. The redemption payment is going to be treated as a sale-or-exchange (so no tax will be paid), because the redemption payment was not made out of the corporation's earnings and profits.

2. Would Sam benefit from § 303 under the following circumstances? (To answer this question, you may have to review § 302 and Schwarz & Lathrope's explanation of what § 302(b)(2) means when it says that redemptions will be treated as exchanges if they are "substantially disproportionate.")
- Earlier this year (2009), Beth passed away leaving her stock in the company to Sam, her only successor.
 - Beth's estate is worth \$4 million, so there will be a \$225,000 estate tax to be paid, for which Sam will need cash.
 - The fair market value of Beth's stock in the corporation on the date of her death was \$1,500,000 (i.e., 37.5% of her estate), though her basis in the stock was just \$50,000.
 - Soon after Beth's death, the corporation redeemed some of Beth's stock for \$225,000. Sam remained the owner of the rest.
 - a. Yes, because under these circumstances, the redemption payment would have been taxed as a dividend under § 302 so he would have had to pay tax on all \$225,000, but as a result of § 303 it will be taxed as a sale-or-exchange so he won't have any tax to pay because he got a step-up in the basis of all the stock he inherited, including the stock the corporation redeemed from him.
 - b. No, once again, the redemption payment will be taxed as a sale-or-exchange under § 302, so Sam doesn't need to rely on § 303 and doesn't need to be concerned about its limitations.
 - c. No. Under these circumstances, the redemption payment would be taxed as a dividend under § 302, but Sam can't rely on § 303 because the payment doesn't come within § 303's limitations.

Redemptions that Liquidate Shareholder's Entire Interest When They are Coupled with Shareholder's Sale of Some Stock

This topic is the result of a judicial opinion and a Revenue Ruling, and its few details appear to be adequately covered in the next reading assignment, so I'll say nothing more about it, except this: I didn't really see what "Redemptions and Sales" (the subtitle of the reading assignment) was referring to, until I read the Examples. Then I saw what those words meant, and why a shareholder might combine a redemption of some shares with a sale of others. So, be sure to read the Examples.

Keep in mind that we're now done with dead shareholders. The next reading assignment, and those that follow, all involve shareholders whose stock is redeemed while they are alive.

Read (in Schwarz & Lathrope)
Pages 218 - 219

Questions re Redemptions that Liquidate Shareholder's Entire Interest When They are Coupled with Shareholder's Sale of Some Stock

3. The corporation formed by Anne, Beth, Carl and Doug had accumulated earnings and profits of \$600,000 at the end of last year. Earlier this year, the corporation redeemed 1/3 of Beth's stock for \$50,000 in cash, and Beth sold the rest of her stock to Doug for \$100,000. The fair market value of Beth's stock was the \$150,000 she received for it, but her basis in the stock was just \$50,000. If the redemption is treated like a sale, just the way the sale to Doug is treated, Beth will have taxable income of \$100,000 (i.e., the difference between her \$50,000 basis and the \$150,000 total she received from the corporation and Doug). On the other hand, if the redemption is treated like a dividend, Beth will have taxable income of \$116,667 consisting of \$50,000 from the dividend plus \$66,667 from the sale to Doug (i.e., \$100,000 minus \$33,333 which was her basis for the 2/3's of her stock that she sold to Doug). How will the redemption of Beth's stock by the corporation be treated?
- It will be treated like a dividend, because the corporation had more accumulated earnings and profits than it distributed to Beth to redeem her stock, so Beth will have taxable income of \$100,000 in all (including her gain on the sale of the rest of her stock to Doug).
 - It will be treated like a sale, because the redemption of 1/3 of Beth's stock by the corporation followed by the sale of the remaining 2/3's to Doug qualifies as a "complete termination" of Beth's interest in the corporation under § 302(b)(3).

Redemptions Resulting from Shareholder Buy-Sell Agreements

This topic too is the result of judicial opinions and a Revenue Ruling, and it too is covered well in the next reading assignment.

The issue here is whether the amount paid by a corporation to redeem the shares of one shareholder (shareholder A) is a constructive dividend to *another* shareholder (shareholder B). If so, it matters whether the amount paid to redeem those shares is a constructive dividend, because dividends are taxable to shareholders who receive them. This means that *if* a redemption payment made to shareholder A is a dividend to shareholder B, the shareholder who receives this "constructive" dividend – shareholder B – is going to have to pay tax on it, even though the actual payment goes to shareholder A.

This issue arises when one shareholder (B) is legally *obligated* to buy the stock of another shareholder (A), but the obligated shareholder (B) gets the corporation itself to redeem the other shareholder's (A's) stock. This is something the obligated shareholder could do quite easily, as a matter of corporate law, whenever the obligated shareholder is the controlling shareholder. (In practice, and in the examples in the reading assignment, the obligated shareholder is in control in all two-shareholder corporations, where the stock of one shareholder is to be redeemed leaving the corporation with just one shareholder – the obligated shareholder.)

Read (in Schwarz & Lathrope)

Pages 219-220

Questions re Redemptions Resulting from Shareholder Buy-Sell Agreements

4. When Anne, Beth, Carl and Doug formed their corporation, they also signed a shareholders' agreement that provided that if any of them died, the survivors were unconditionally obligated to buy the deceased shareholder's stock for its fair market value at that time. Later, Beth passed away. On the date of her death, the corporation had accumulated earnings and profits of \$600,000, and the fair market value of Beth's stock was \$150,000. Anne, Carl and Doug did not then have \$50,000 in cash each to buy Beth's stock, and they didn't want the corporation to distribute cash to them, because the distribution would have been a dividend. (You see why, don't you?) So, instead of redeeming Beth's stock themselves, Anne, Carl and Doug voted to have the corporation itself redeem Beth's stock. Did they accomplish their (tax) mission?
 - a. Yes, because Beth's entire interest in the corporation was terminated, so under § 302(b)(3), the distribution will be treated as the sale of Beth's stock to the corporation rather than as a dividend paid to her.
 - b. No. Although answer "a" is correct as to the tax consequences to *Beth*, the (tax) mission that Anne, Carl and Doug wanted to accomplish was to redeem Beth's stock (as required by their shareholder's agreement) in a way that was tax-free to them; and this they didn't do, because the payment the corporation made to Beth will be deemed a "constructive dividend" to *them* – and as such, taxable to them.

5. When Anne, Beth, Carl and Doug formed their corporation, they also signed a shareholders' agreement that provided that if any of them died, the corporation had the option to purchase the deceased shareholder's stock for its fair market value at that time, and if the corporation did not exercise its option, the surviving shareholders would be unconditionally obligated to do so. Later, Beth passed away. On the date of her death, the corporation had accumulated earnings and profits of \$600,000, and the fair market value of Beth's stock was \$150,000. The corporation exercised its option to buy Beth's stock for \$150,000, and did so. What will the tax consequences be to Beth's estate and to Anne, Beth, Carl and Doug?
 - a. Beth's entire interest in the corporation was terminated, so under § 302(b)(3), the distribution will be treated as the sale of Beth's stock to the corporation rather than as a dividend paid to her; and the corporation's payment to Beth would not be a constructive dividend to Anne, Carl and Doug, because they were not *primarily* obligated to buy Beth's stock.
 - b. Beth's entire interest in the corporation was terminated, so under § 302(b)(3), the distribution will be treated as the sale of Beth's stock to the corporation rather than as a dividend paid to her; and the corporation's payment to Beth will be deemed a "constructive dividend" to Anne, Carl and Doug – and as such, taxable to them – because if the corporation had not exercised its option, they would have been obligated to buy Beth's stock themselves.

Redemptions Resulting from Divorce

Sometimes, one shareholder's *obligation* to buy another shareholder's stock arises this way: the two shareholders were married; they got divorced; the divorce settlement required one of them to buy the other's stock; but the obligated shareholder had the *corporation* buy it instead.

The issue in cases like this is whether the spouse who should have purchased the other's stock received a constructive dividend, when the corporation redeemed that stock itself. The reason this is a more involved constructive dividend issue than the one that arises from buy-sell agreements between folks who are not married and not getting divorced is this: you'll recall from the Survey course that Code § 1041 provides that the transfer of property between spouses, or in connection with their divorce, is *not* a taxable transaction. This means that if Wife transfers stock in which her basis is \$50,000 to Husband in return for \$100,000 in cash, Wife does not have taxable income and Husband has a basis in that stock of only \$50,000. This also is so, regardless of whether Husband and Wife remain married or whether (as is more often the case in the real world) they make this transfer in connection with their divorce.

The issue addressed in the next reading assignment is whether § 1041 produces the same result if the stock transferred by the Wife is stock in a corporation controlled by the Husband, so the Husband is able to, and does, have the corporation redeem the Wife's stock itself, instead of buying it himself. In other words, the issue is whether the corporation's redemption of the Wife's stock is tax-free to her, and if so, whether it's tax-free to the Husband as well.

By the way, this next bit may be obvious, but I want to state it anyway just in case some of you take these Study Guides quite literally: I've used the words "Husband" and "Wife" simply because gender-neutral terms made the preceding paragraphs difficult to understand. The law, of course, is gender-neutral. It yields the same result regardless of whether the spouse whose stock is redeemed is the Husband or the Wife and regardless of whether the spouse who remains a shareholder is the Wife or the Husband.

Read (in Schwarz & Lathrope)

Pages 220-222

Questions re Redemptions Resulting from Divorce

6. Anne and Carl are married, but they're getting a divorce. As part of their settlement, Carl agreed to pay Anne \$150,000 in cash for her stock in the corporation – stock in which Anne has a basis of \$100,000. Their agreement makes Carl unconditionally obligated to do this. But before he does, Beth and Doug object, because Carl's purchase of Anne's shares would make Carl the owner of 50% of the company, and Beth and Doug want all three of them to remain equal shareholders. As a result, Carl, Beth and Doug agree (among themselves) that instead of Carl buying Anne's stock, the corporation itself will redeem it. The corporation has accumulated earnings and profits of \$600,000. Which of the following possibilities would be the actual tax consequences to Anne of the corporation redeeming Anne's stock, under these circumstances?
 - a. Anne will have \$150,000 in dividend income.
 - b. Anne will have \$50,000 in income from the sale of stock.
 - c. Anne will not have taxable income.

7. Which of the following possibilities would be the actual tax consequences to Carl of the corporation redeeming Anne's stock, under the circumstances described in Question 6?
 - a. Carl will have dividend income of \$150,000.
 - b. Carl will have \$100,000 in income from the sale of the stock.
 - c. Carl will not have taxable income.

8. Anne and Carl are married, but they're getting a divorce. As part of their settlement, Carl agreed to: have the corporation redeem Anne's stock for \$150,000, and if it failed to do so, to buy her stock himself. Before Carl decided what to do, he consulted Beth and Doug. They didn't want Carl purchase of Anne's shares because that would have made Carl the owner of 50% of the company, and Beth and Doug wanted all three of them to remain equal shareholders. As a result, Carl, Beth and Doug agreed that the corporation itself would redeem Anne's stock; and it did. The corporation had accumulated earnings and profits of \$600,000. Which of the following possibilities were the tax consequences to Anne and Carl?
 - a. Anne had \$150,000 in dividend income.
 - b. Anne had \$50,000 in income from the sale of the stock.
 - c. Anne had no taxable income.

9. Which of the following possibilities were the tax consequences to Anne and Carl, under the circumstances described in Question 7?
 - a. Carl had dividend income of \$150,000.
 - b. Carl had \$100,000 in income from the sale of the stock.
 - c. Carl had no taxable income.

Redemptions Resulting from Charitable Contributions

This topic is the result of a judicial opinion and Revenue Ruling, and it too is covered well in the next reading assignment.

Read (in Schwarz & Lathrope)

Page 222

Questions re Redemptions Resulting from Charitable Contributions

10. Doug is an avid supporter of a local charity, to which he has decided to make a \$25,000 contribution this year. He doesn't have that much cash on hand right now. But his stock in the corporation that he owns with Anne, Beth and Carl is worth \$100,000, the corporation has enough cash on hand to redeem \$25,000 worth of this stock, and the corporation has accumulated earnings and profits of \$100,000. Doug is willing to part with \$25,000 worth of his stock, in order to make the \$25,000 charitable contribution. Should he redeem that much stock himself, and contribute the cash to the charity? Or should he contribute that much stock to the charity, and let the charity redeem it (if it wishes to)?
- a. Doug should redeem the stock himself and contribute the cash to charity, because that involves the fewest steps, and the cash he receives when he redeems his stock will not be income to him, because the corporation has sufficient earnings, profits and cash to cover the redemption.
 - b. Doug should contribute the stock to the charity and allow the charity itself to redeem the stock (if it wishes to), because if he redeems the stock himself, the cash he receives will be a taxable dividend to him, but if the charity redeems the stock, it will not be a dividend to him at all (and thus not taxable to him).

Study Guide 22

TRANSFERRING A BUSINESS

Transferring a Partnership's Business

Transferring a Corporation's Business

Transferring Assets in a Taxable Transaction

Transferring Stock in a Taxable Transaction

Transferring a Partnership's Business

The legal principles that control the tax consequences of transferring a partnership's business logically fit right here. However, it will be easier to understand those principles if they are studied a bit later in the semester. As a result, we'll look at those principles in Study Guide 25, at the same time we look at some other related principles, all of which fall under the heading "Making Major Changes in the Ownership of a Partnership's Business."

Transferring a Corporation's Business

In Study Guides 20 and 21, we looked at transfers of a shareholder's stock in a corporation, where the corporation itself continued to do business and was still owned by some of the same shareholders (those who didn't transfer their stock) and (perhaps) by a new shareholder (if the transfer was to a new shareholder, rather than to existing shareholders or to the corporation itself in a redemption).

Now, we will look at an entirely different situation – one in which corporation's entire business is transferred to entirely new owners. As you'll see, this can be done in either of two ways: by having the corporation sell all of its *assets* to a new owner; or by having the corporation's old owners sell all of their *stock* to a new owner.

Schwarz and Lathrope address these transactions from the point of view of the new owner. For that reason, the following reading assignments refer to the new owner as "P" for "purchaser" and to the old owner's corporation as "T" for "target." We, on the other hand, have spent the entire semester viewing transactions from the point of view of Anne, Beth, Carl and Doug, who in this Study Guide will be *selling* their corporation, not buying another. As a result, Schwarz & Lathrope's "T" is the corporation owned by Anne, Beth, Carl and Doug, while "P" is the buyer of their stock or the corporation's assets.

Read (in Schwarz & Lathrope)

Pages 258 (paragraph D.1.)

Transferring Assets in a Taxable Transaction

Tax considerations aside, buyers usually prefer to buy a corporation's assets rather than its stock, because if they buy its assets, the corporation's liabilities stay with the corporation and aren't transferred to the buyer.

The tax aspects of a corporation's sale of its assets aren't complicated, to the seller or the buyer. (We'll consider the tax consequences to the shareholders of the selling corporation in Study Guide 26, so don't concern yourself with those now.)

The only point that may contain complications is the question of how the purchase price should be allocated for the purpose of determining: the corporation's gain from the sale of its assets; and the buyer's basis in the purchased assets. The reading assignment has a nice explanation of the sections of the Code and Regulations that answer this question. In most cases, though, it looks to me as though the answers would be obvious. The questions below are designed to illustrate circumstances where the answers should be obvious, and those where the allocation rules in the Regulations might be necessary, and why – from the Treasury's point of view – they are necessary.

Read (in Schwarz & Lathrope)

Pages 259-261

Questions re Transferring Assets in a Taxable Transaction

1. The corporation formed by Anne, Beth, Carl and Doug has been in existence for a number of years, and they've decided that the continued operation of the business isn't really worth the time, effort and investment that it requires, so they've decided to sell the business. They've found a purchaser who's willing to buy the corporation's assets for their fair market value. Those assets now consist of:
 - the real estate (originally contributed by Beth) the fair market value of which is still \$100,000 and in which the corporation still has a basis of \$50,000,
 - the equipment (originally contributed by Carl) the fair market value of which is still \$100,000 and in which the corporation now has a basis of \$0 (because the corporation took \$25,000 in depreciation deductions since acquiring the equipment from Carl with his old basis of \$25,000), and
 - furniture and fixtures (which it bought using some of the cash contributed by Anne) the fair market value of which is \$25,000, though the corporation paid \$35,000 for it and then took \$10,000 in depreciation so the corporation's basis for it is \$25,000.

How much gain will the corporation have on the sale of its assets?

- a. \$75,000.
 - b. \$150,000.
 - c. \$225,000.
 - d. It depends on how the purchase price is allocated among the assets.
2. Same facts as Question 1. What will the purchaser's basis be in the assets?
 - a. \$75,000.
 - b. \$150,000.
 - c. \$225,000.
 - d. It depends on how the purchase price is allocated among the assets.

3. Same facts as Question 1, with this exception. The purchaser is willing to pay \$300,000 for the corporation's assets, i.e., \$75,000 more than the assets' fair market value. How much gain will the corporation have on the sale of its assets?
 - a. \$150,000.
 - b. \$225,000.
 - c. \$300,000.
 - d. It depends on how the purchase price is allocated among the assets.
4. Same facts as Question 3. What will the purchaser's basis be in the assets?
 - a. \$150,000.
 - b. \$225,000.
 - c. \$300,000.
 - d. It depends on how the purchase price is allocated among the assets.

Transferring Stock in a Taxable Transaction

When all of a corporation's shareholders sell all of their stock to a purchaser, there are three sets of tax consequences:

- those to the selling shareholders;
- those to the purchaser; and
- those to the acquired corporation.

The first two consequences are easy:

- The selling shareholders realize a taxable gain or loss on the sale of their stock.
- The purchaser's basis in the acquired stock is whatever amount the purchaser paid for it, unless a "338 election" is made.

It's the consequences to the acquired corporation that can get a bit tricky. At first blush, it may not be apparent why there are consequences at all to the acquired corporation. All that has happened is that its shareholders have changed. When a shareholder in a publicly-traded corporation sells his or her stock, there aren't any tax consequences to the corporation itself. If there were, public corporations wouldn't have time to do anything at all, other than deal with the tax consequences of the daily changes in their stockholders.

However, in this Study Guide we're not talking about publicly-owned corporations. We're talking about corporations that have few enough shareholders that all of them agree to sell their stock at the same time to the same purchaser (technically, enough of them agree to sell their stock at roughly the same time to the same purchaser so that the purchaser winds up with 80% or more of the corporation's stock).

In this situation, the issue is what becomes of the corporation's basis in its own assets, after the purchase of its stock. The reason this matters is that the amount the purchaser paid for the corporation's stock may be more than the corporation's basis in its assets.

- If the corporation's basis in its assets doesn't change, then the acquisition of its stock should not be a taxable transaction to the corporation. But the corporation may realize a taxable gain later when it sells those assets, even if it sells them for the same amount (or less) than what the purchaser paid for the stock.
- However, if the corporation's basis in its assets is adjusted (to match what the purchaser paid for the stock), the corporation would not realize a gain if it sells its assets for the same amount (or less) than what the purchaser paid for the stock. But if this is the law, it's necessary to determine whether the acquisition of its stock is a taxable transaction to the corporation.

Back when I was a law student, the *Kimbell-Diamond* case (described in Schwarz & Lathrope at page 262) was a *very* important decision. Today, things are much easier (or maybe harder), because we have Code § 338. That section permits purchasers of 80% or more of the stock of a corporation to elect what to do about the basis of the corporation's assets. Section 338 elections are what the following reading assignment is about.

In a nutshell, if the purchaser makes a § 338 election, the basis of the corporation's assets is adjusted to match the price the purchaser paid for the corporation's stock, and the corporation recognizes a gain or loss on the difference between the corporation's newly-adjusted basis and its pre-purchase basis.

Section 338 contains a host of exquisite complications that deal with: the timing of stock purchases (where it takes more than one purchase to reach 80%); the timing of the election; the formula that's used to determine the amount of the corporation's gain (or loss) if the purchaser makes an election; and the formula that's used to determine gain (or loss) if the purchaser buys less than 100% (but 80% or more) of the corporation's stock. For our purposes, though, it's the basic concept that's important (as illustrated in the questions below).

Read (in Schwarz & Lathrope)

Pages 261-268

Page 272 (paragraph 5)

Questions re Transferring Stock in a Taxable Transaction

5. The corporation formed by Anne, Beth, Carl and Doug has been in existence for a number of years, and they've decided that the continued operation of the business isn't really worth the time, effort and investment that it requires, so they've decided to sell the business. They've found a purchaser who's willing to buy all of their stock in the corporation for \$225,000 which is the fair market value of its assets. Those assets now consist of:
- the real estate (originally contributed by Beth) the fair market value of which is still \$100,000 and in which the corporation still has a basis of \$50,000,
 - the equipment (originally contributed by Carl) the fair market value of which is still \$100,000 and in which the corporation now has a basis of \$0 (because the corporation took \$25,000 in depreciation deductions since acquiring the equipment from Carl with his old basis of \$25,000), and
 - furniture and fixtures (which it bought using some of the cash contributed by Anne) the fair market value of which is \$25,000, though the corporation paid \$35,000 for it and then took \$10,000 in depreciation so the corporation's basis for it is \$25,000.

What will the tax consequences of the sale be to Anne, Beth, Carl and Doug?

- a. Each of them will realize a gain of \$56,250, i.e., 25% of the amount paid by the purchaser.
 - b. Each of them will realize a loss of \$43,750, i.e., 25% of the difference between the amount paid by the purchaser and the original \$400,000 aggregate value of their stock.
 - c. Anne will realize a loss of \$43,750 (the difference between her \$100,000 basis in her stock and \$56,250 which is her 25% of the \$225,000 paid by the purchaser); Beth will realize a gain of \$6,250 (the difference between her \$50,000 basis and \$56,250); Carl will realize a gain of \$31,250 (the difference between his \$25,000 basis and \$56,250); and Doug will realize a loss of \$43,750 (the difference between his \$100,000 basis and \$56,250).
 - d. It depends on how the purchase price is allocated among the assets.
6. Same facts as Question 5. What is the purchaser's basis in the stock?
- a. \$75,000.
 - b. \$150,000.
 - c. \$225,000.
 - d. It depends on how the purchase price is allocated among the assets.

7. Same facts as Question 5. What are the tax consequences to the corporation if the purchaser does *not* make a § 338 election?
- It will recognize a gain of \$150,000 (the difference between the \$225,000 paid for its stock, and its \$75,000 basis in its assets).
 - It will not recognize a gain, but its basis in its assets will be increased to \$225,000.
 - It will not recognize a gain, but its basis in its assets will remain \$75,000, so if it were to sell those assets immediately after purchaser acquired its stock, the corporation would have a \$150,000 gain.
 - It depends on how the purchase price is allocated among the assets.
8. Same facts as Question 5. What are the tax consequences to the corporation if the purchaser *does* make a § 338 election?
- It will recognize a gain of \$150,000 (the difference between the \$225,000 paid for its stock, and its \$75,000 basis in its assets).
 - It will not recognize a gain, but its basis in its assets will be increased to \$225,000.
 - It will not recognize a gain, but its basis in its assets will remain \$75,000, so if it were to sell those assets immediately after purchaser acquired its stock, the corporation would have a \$150,000 gain.
 - It depends on how the purchase price is allocated among the assets.
9. Same facts as Question 8 (i.e., the purchaser does make a § 338 election). What is the purchaser's basis in the stock?
- \$225,000 – the amount the purchaser paid for it.
 - \$262,500, calculated this way: If the answer to Question 8 is "a" – the corporation will recognize a gain of \$150,000 – the corporation will have to pay tax on that gain. If the corporation is in the 25% bracket, it will pay a tax of \$37,500 (25% x \$150,000). And since the purchaser now owns the corporation, the tax will in effect be paid by the purchaser, so the purchaser really will have paid \$262,500 for the stock (\$225,000 + \$37,500), allocated as follows:
 - real estate \$100,000 (its fair market value)
 - equipment \$100,000 (its fair market value)
 - furniture etc. \$ 25,000 (its fair market value)
 - goodwill \$ 37,500 (residual amount)
 - \$262,500

Study Guide 23

TRANSFERRING A BUSINESS

Transferring a Corporation's Business

Reorganizing a Corporation, Tax-Free

Reorganizing a Corporation, Tax-Free

Corporations are reorganized for a host of reasons having nothing to do with tax, and they have been for a long time. Early on, in the 1920s, before the Internal Revenue Code said much about corporate reorganizations, the Supreme Court held that reorganizations were taxable transactions, so if shareholders realized gain, they had to recognize income. These cases involved significant reorganizations like mergers and stock or asset acquisitions, and minor changes too like changes in a company's state of incorporation (often from its original state to Delaware).

In the Survey course and earlier in this course, we looked at several Code provisions that permit taxpayers to postpone paying tax in connection with transactions that merely change their investment from one thing to another (so long as, or to the extent that, their investment isn't changed into cash). The Supreme Court's early decisions in the corporate reorganization area required shareholders to pay tax when their investment changed from stock in one company to stock in another (even if they didn't receive cash in the process). So Congress "came to the rescue" (in the words of Schwarz & Lathrope, in their full casebook), by enacting what are now the corporate reorganization sections of the Code.

The corporate reorganization sections of the Code, along with related judicial decisions, make up (again in the words of Schwarz & Lathrope, in their casebook) "a vast and challenging body of law that governs some of the most financially significant transactions in the business world." According to Professors Boris Bittker and James Eustice – authors of the treatise *Federal Income Taxation of Corporations and Shareholders* – the corporate reorganization sections are "extraordinarily complex, even for the [Internal Revenue] Code."

As is often the case, much of the Code's complexity flows from Congress' desire to give taxpayers a break while limiting that break to taxpayers who are involved in *certain kinds* of transactions. Insofar as corporate reorganizations are concerned, Congress wanted to allow shareholders to postpone paying tax on gains they may realize, *if* those gains are realized as a result of a reorganization that is one of several *particular* types. As you'll see from the next reading assignment, there are seven types of reorganizations that are blessed as "tax-free." These seven types have been given very unglamorous and completely non-descriptive letter-names ranging from "Type A Reorganizations" through "Type G Reorganizations." These letters refer to the subparagraphs of § 368(a)(1) that define each type of reorganization that's eligible for deferred tax treatment.

Section 368 reorganizations are called "tax-free" reorganizations – rather than "deferred-tax" reorganizations – because no tax is due *at the time of the reorganization*. Instead, basis is carried over (in ways we'll look at below), so that gains (or losses) are taxed (or deducted) later, when some other event occurs.

There are two parts to the tax law of corporate reorganizations. The first part involves determining *whether* a particular reorganization qualifies as a tax-free reorganization. If it *does*, that leads to the second part: determining *what* the tax consequences are. If the reorganization does *not* qualify as tax free, that simply means that it's treated like a taxable transfer of assets or stock – the very treatment that we looked at in Study Guide 22.

Whether a Reorganization Qualifies as a Tax-Free Reorganization

Read (in Schwarz & Lathrope)

Pages 293-297

In this Study Guide, we're going to focus on three types of reorganizations:

- Type A Reorganizations, which are
 - *mergers* in which the stock of the acquiring corporation (P) is distributed to the shareholders of the acquired corporation (T), and the acquired corporation is liquidated, automatically as a matter of state law, and
 - *consolidations*, in which two corporations are consolidated into one new corporation, and stock of the new consolidated corporation is distributed to the shareholders of the two old corporations.
- Type B Reorganizations, which are *stock-for-stock* deals in which the acquired corporation (T) remains in existence as a subsidiary of the acquiring corporation (P), and
- Type C Reorganizations, which are *stock-for-assets* deals in which the acquired corporation (T) liquidates and distributes to its shareholders the stock of the acquiring corporation (P).

Here is the Code provision that defines these three types of reorganizations:

§ 368. Definitions relating to corporate reorganizations

(a) Reorganization

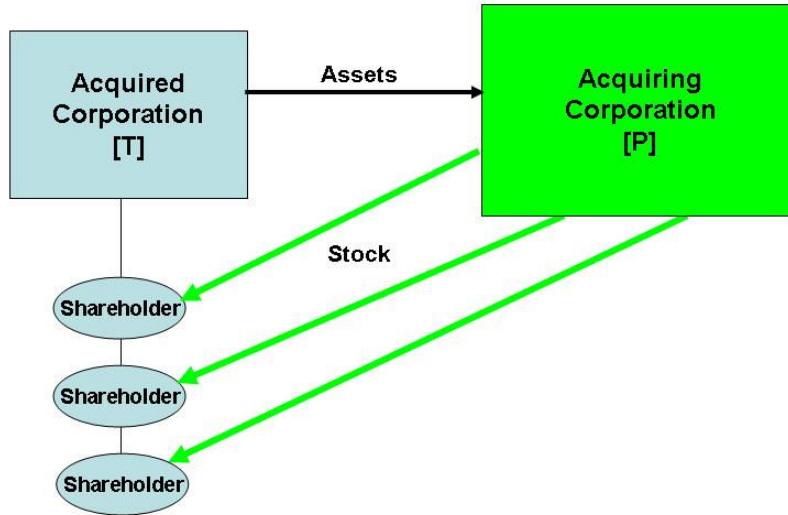
(1) In general. . . . the term "reorganization" means -

- (A) a statutory merger or consolidation;
- (B) the acquisition by one corporation, in exchange *solely* for all or a part of its *voting stock* . . . , of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation . . . ;
- (C) the acquisition by one corporation, in exchange *solely* for all or a part of its *voting stock* . . . of *substantially all of the properties* of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other shall be disregarded. . . .

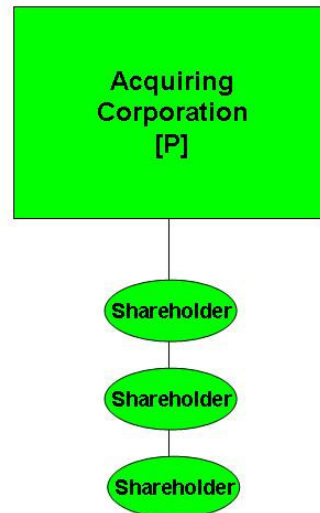
[Emphasis added]

The charts on the following pages are diagrams of the steps involved in each of these types of reorganizations.

Type A Reorganization – Merger
Step 1

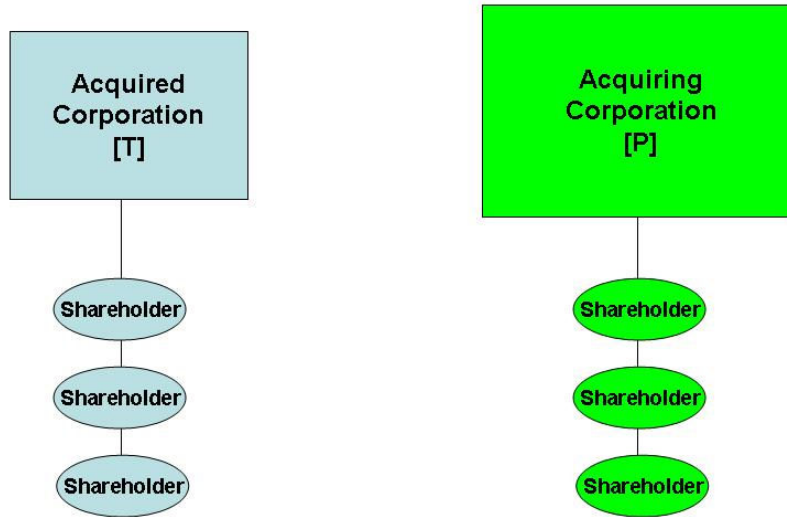


Type A Reorganization – Merger
Step 2



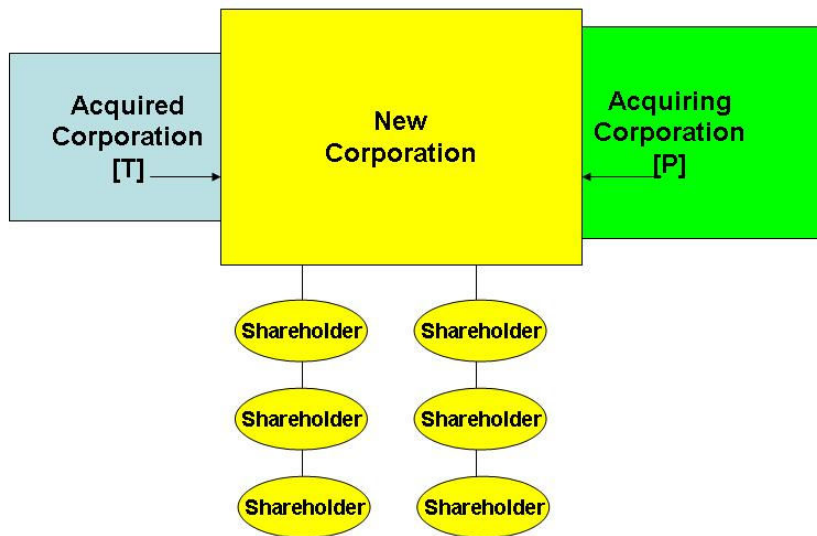
Type A Reorganization – Consolidation

Step 1

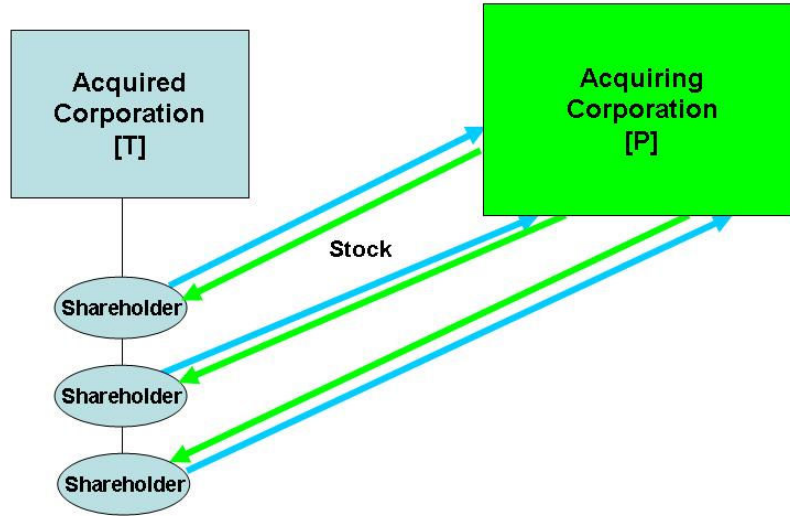


Type A Reorganization – Consolidation

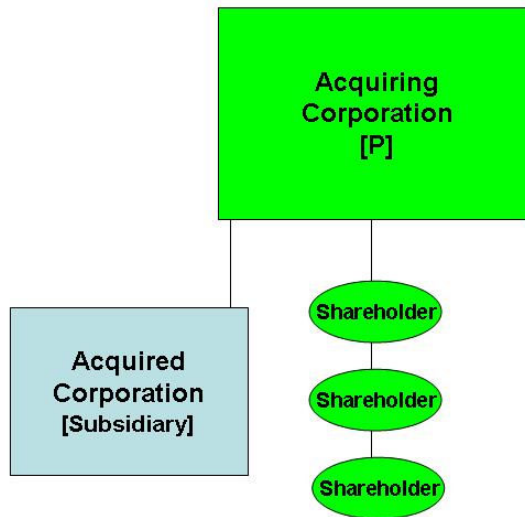
Step 2

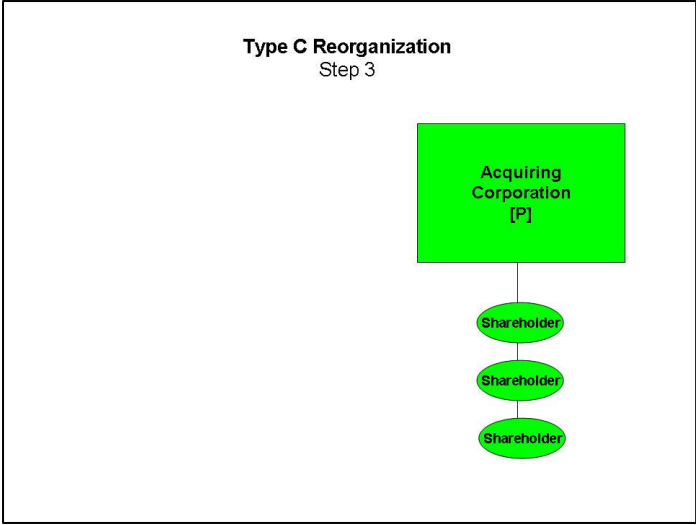
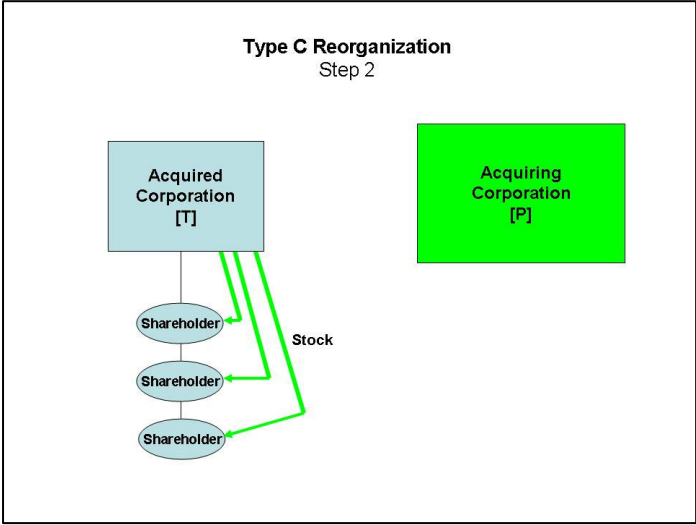
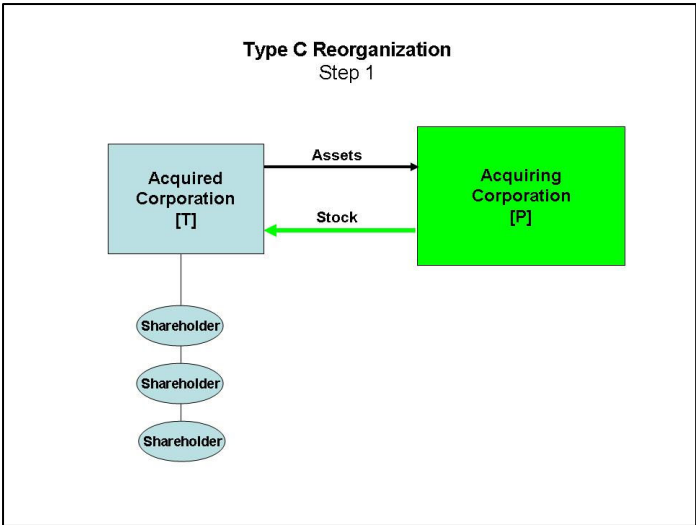


Type B Reorganization Step 1



Type B Reorganization Step 2





Questions re Whether a Reorganization Qualifies as a Tax-Free Reorganization

1. The corporation formed by Anne, Beth, Carl and Doug has been doing well, and another corporation (which we'll call "Purchaser") would like to acquire their company. Purchaser wants to acquire their company, because it's in the same line of business in another part of the country; and Purchaser wants to expand its operations into their company's part of the country. Anne's basis in her stock is \$100,000; Beth's is \$50,000; Carl's is \$25,000; and Doug's is \$100,000. But their corporation is now valued at \$20 million – \$5 million for each of their 25% shareholdings – so if Purchaser acquires their company in a taxable transaction, each of them will have a sizeable tax to pay. As a result, they are hoping to find a tax-free way to have Purchaser acquire their company. Here are the transactions that are being considered. Which of them will be a tax-free reorganization? (Circle all that are, and for any that are not, make a note to yourself in the margin about why they aren't.)
 - I. Purchaser will pay the corporation owned by Anne, Beth, Carl and Doug \$20 million – half in cash, and the other half in bonds (i.e., long-term promissory notes) – in return for all of their corporation's assets.
 - II. Purchaser will give Anne, Beth, Carl and Doug preferred but non-voting stock in Purchaser worth \$5 million, each, in return for their stock in their company.
 - III. Purchaser will give Anne, Beth, Carl and Doug voting stock in Purchaser worth \$5 million, each, in return for their stock in their company.
 - IV. Purchaser will give the corporation owned by Anne, Beth, Carl and Doug \$20 million worth of Purchaser voting stock in return for all of their company's assets.
 - V. The corporation owned by Anne, Beth, Carl and Doug will be merged into Purchaser, and \$20 million worth of Purchaser voting stock will be issued to Anne, Beth, Carl and Doug, \$5 million worth to each.
 - a. All will be tax-free.
 - b. None will be tax-free.
 - c. I and II will be tax-free; the others will be taxable.
 - d. III, IV and V will be tax-free; the others will be taxable.
2. Suppose that Purchaser wants to buy the corporation owned by Anne, Beth, Carl and Doug solely in order to get their company's real estate, and Purchaser doesn't intend to continue their company's line of business at all. Would that change your answers to Question 1?
 - a. No. (Why not?)
 - b. Yes. (Why?)

The Tax Consequences of a § 368 Reorganization

Read (in Schwarz & Lathrope)

Pages 318 (paragraph 7) – 319 (up to paragraph b)

So far, I've described § 368 reorganizations as "tax-free" or "tax-deferred," but it's a bit more complicated than that, as I'm sure you suspected. There are three sets of tax consequences that must be considered:

- those to the acquired corporation's shareholders,
- those to the acquired corporation itself, and
- those to the purchasing corporation.

Let's take them one at a time.

To the Acquired Corporation's (T) Shareholders

Read (in Schwarz & Lathrope)

Pages 319-323

Here are the Code sections that make qualified reorganizations (i.e., those that fit the definitions in § 368) "tax-free."

§ 368. Definitions relating to corporate reorganizations

- ...
- (b) Party to a reorganization. For purposes of this part, the term "a party to a reorganization" includes -
- (1) a corporation resulting from a reorganization, and
 - (2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

§ 354. Exchanges of stock and securities in certain reorganizations

- (a) General rule
- (1) In general. No gain or loss shall be recognized if stock . . . in a corporation a party to a reorganization [is], in pursuance of the plan of reorganization, exchanged solely for stock . . . in another corporation a party to the reorganization.

§ 358. Basis to distributees

- (a) General rule. In the case of an exchange to which section . . . 354 . . . applies -
- (1) Nonrecognition property. The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged. . . .

§ 1223. Holding period of property

- For purposes of this subtitle -
- (1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and . . . the property exchanged at the time of such exchange was a capital asset . . . or property [used in a trade or business]. . . .

Section 368(b) is simply a definition of the phrase “a party to a reorganization.” The definition seems obvious, but as it’s used in § 354(a), the phrase is awkward, so I decided to give you the definition, so you’d have no doubts.

Section 354(a) is the source of the notion that qualified reorganizations are “tax-free,” because it provides that “no gain . . . shall be recognized.” Notice, though, that the language of § 354(a) only covers stock-for-stock exchanges. Type B reorganizations are stock-for-stock, so § 354(a) makes them “tax-free.” But how do Type A and C reorganizations get tax-free treatment?

Type A reorganizations also are covered by § 354(a), because in a merger or consolidation, shareholders of the target corporation wind up with stock in the purchasing or consolidated corporation.

Type C reorganizations are covered by § 354(a) as well, even though they involve stock-for-assets, because the shareholders of the corporation whose assets are acquired wind up with the stock of the purchasing corporation (as a result of the liquidation of their corporation).

Sections 358 and 1223(1) are why qualified reorganizations aren’t really “tax-free” so much as “tax-deferred.” Section 358 sticks the recipients of the purchasing corporation’s stock with the same basis they had in their stock in their old corporation, though § 1223(1) gives them the same holding period in their new stock as they had in their old (for the purpose of determining whether their eventual gains or losses are long or short-term). If their new stock is worth more than their old – so they actually do avoid paying tax on their gain from the reorganization – they’ll pay tax eventually, when they sell their new stock (assuming, of course, it’s still worth more than their old, when they sell).

So far, so good. There’s one more Code section that affects the tax treatment of the shareholders of acquired corporations. Section 356(a) is – at one and the same time – both familiar and puzzling. It’s familiar in the sense that it provides that if shareholders in an acquired corporation receive money or property in addition to stock, the money or property will be taxable boot. There are “boot-is-taxable” provisions like this one elsewhere in the Code – provisions that you studied in the Survey course and earlier in this course as well.

§ 356. Receipt of additional consideration

- (a) Gain on exchanges
 - (1) Recognition of gain. If -
 - (A) section 354 . . . would apply to an exchange but for the fact that
 - (B) the property received in the exchange consists not only of property permitted by section 354 . . . to be received without the recognition of gain but also of other property or money,then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.
 - (2) Treatment as dividend. If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend . . . , then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation. . . . The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

Section 356(a) makes sense in connection with Type A reorganizations, because §368(a)(1)(A) does *not* require mergers and consolidations to be *entirely* stock-for-stock. (Look back at page 2 of this Study Guide to confirm this.) As it happens, the IRS requires at least 40% — 50% is safer — of the consideration paid by the Purchaser to be stock in the Purchaser (though it doesn't have to be voting stock). (This is explained at page 298 of Schwarz & Lathrope — a page that wasn't in the assigned reading.) But the 40%-to-50% stock requirement means that a Type A reorganization qualifies for "tax-free" treatment, even if shareholders in the acquired corporation get some cash or property too. If they do, §356(a) says that if they *realize* a gain as a result of the Type A reorganization, they must *recognize* that gain to the extent of the cash or property they receive.

However, § 356(a) is puzzling in connection with Type B and C reorganizations, because §368(a)(1)(B) and §368(a)(1)(C) both require the Purchaser to acquire the other corporation's stock or assets "in exchange *solely* for all or a part of [the Purchaser's] *voting stock*." (Emphasis added. Look back at page 2 of this Study Guide to confirm this too.) If the acquiring corporation must use only its stock, there can't be any boot for § 356(a) to deal with. Right?

The answer is: half-right. It's right with respect to Type B stock-for-stock reorganizations. As to those, even a small amount of boot will make the whole reorganization a taxable one. (For authority, see Schwarz & Lathrope at page 305 (not assigned reading).)

But with respect to Type C stock-for-assets reorganizations, there can be some boot without disqualifying the entire reorganization for tax-free treatment. The reason for this is that although § 368(a)(1)(C) requires the Purchaser to pay with voting stock, it only requires the Purchaser to acquire "substantially all" of the other corporation's assets for stock. This means that some of the other corporation's assets can be acquired for cash, without disqualifying the stock-for-assets portion for tax-free treatment. Section 356(a) makes the cash-for-assets part taxable. Of course, complications are added by the question of how many assets are "substantially all," and the question about what happens if some of the acquired assets are subject to debt that is also acquired by the Purchaser. Without getting into these complications, the result is that it's likely that a reorganization that combines stock with cash and assumption of debt will not qualify as a Type C tax-free reorganization. (If you're curious, see Schwarz & Lathrope at page 308-310 (not assigned).)

Questions re Tax Treatment of Acquired Corporation's Shareholders

3. The corporation formed by Anne, Beth, Carl and Doug has been doing well, and another corporation ("Purchaser") would like to acquire to acquire their company. Purchaser wants to acquire their company, because it's in the same line of business in another part of the country; and Purchaser wants to expand its operations into their company's part of the country. Anne's basis in her stock is \$100,000; Beth's is \$50,000; Carl's is \$25,000; and Doug's is \$100,000. But their corporation is now valued at \$20 million – \$5 million for each of their 25% shareholdings. What will the tax consequences be to Anne, Beth, Carl and Doug, if Purchaser acquires their stock from them, in exchange for \$5 million (each) of Purchaser's voting stock?
- Each of them will realize and recognize a gain in the following amounts:

Anne	\$4,900,000	(\$5,000,000 - \$100,000)
Beth	\$4,950,000	(\$5,000,000 - \$50,000)
Carl	\$4,975,000	(\$5,000,000 - \$25,000)
Doug	\$4,900,000	(\$5,000,000 - \$100,000)
 - None of them will have a gain, ever.
 - None of them will have a gain when the reorganization takes place, but if and when they sell their stock in Purchaser, they will have to pay tax on the full amount they receive when the sell that stock.
 - None of them will have a gain when the reorganization takes place, but if and when they sell their stock in Purchaser, they will have to pay tax on the difference between the amount they receive when they sell that stock and their basis in the stock in their original corporation.
4. Same facts as Question 3, with this change: What will the tax consequences be to Anne, Beth, Carl and Doug, if their corporation is merged into Purchaser in exchange for \$16 million worth of Purchaser's stock plus \$4 million in cash, of which \$4 million in stock plus \$1 million in cash is distributed to each of them?
- Each of them will realize and recognize a gain in the following amounts:

Anne	\$4,900,000	(\$5,000,000 - \$100,000)
Beth	\$4,950,000	(\$5,000,000 - \$50,000)
Carl	\$4,975,000	(\$5,000,000 - \$25,000)
Doug	\$4,900,000	(\$5,000,000 - \$100,000)
 - Each of them will *realize* a gain in the amounts set forth in answer "a" but each will have to *recognize* a gain of only \$1 million.
 - None of them will have a gain when the reorganization takes place, but if and when they sell their stock in Purchaser, they will have to pay tax on the \$1 million in cash they received plus the difference between the amount they receive when the sell that stock and their basis in the stock in the corporation they organized.

To the Acquired Corporation Itself (T)

Read (in Schwarz & Lathrope)

Pages 323-325

In a Type B stock-for-stock reorganization, there aren't any tax consequences to the acquired corporation, because from its point of view, only its owners have changed. The acquired corporation itself doesn't receive or give up anything.

In a Type C stock-for-assets reorganization, there are some tax consequences, because the acquired corporation transfers its assets in exchange for stock which it distributes to its shareholders when it liquidates as part of the reorganization.

A Type A merger-or-consolidation also involves one corporation transferring its assets to another, in exchange for stock which is automatically distributed to its shareholders when it liquidates.

Because the acquired corporation exchanges its assets for another corporation's stock in Type A and C reorganizations, the acquired corporation will *realize* a gain whenever its basis in the exchanged assets is less than the value of stock it receives. Here is what the Code has to say about the tax consequences to the acquired corporation, in Type A and C reorganizations. (Keep in mind the difference between *realizing* a gain and *recognizing* one.)

§ 361. Nonrecognition of gain or loss to corporations; treatment of distributions

(a) General rule. No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

. . .

(c) Treatment of distributions

(1) In general. Except as provided in paragraph (2), no gain or loss shall be recognized to a corporation a party to a reorganization on the distribution to its shareholders of property in pursuance of the plan of reorganization.

(2) Distributions of appreciated property

(A) In general. If -

- (i) in a distribution referred to in paragraph (1), the corporation distributes property *other than* qualified property, and
 - (ii) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),
- then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

(B) Qualified property. For purposes of this subsection, the term "qualified property" means -

- (i) any stock in . . . the distributing corporation . . . , or
- (ii) any stock in . . . another corporation which is a party to the reorganization . . . if such stock . . . is received by the distributing corporation in the exchange.

[Emphasis added.]

In plain English, § 361(a) means that an acquired corporation does not recognize gains from the exchange of its assets for another corporation's stock. And § 361(c) means that an acquired corporation does not recognize gains from the distribution to their shareholders of the other corporation's stock. (The stock referred to in § 361(c)(2)(B)(i) is the stock of a merged or consolidated corporation resulting from a Type A reorganization. And the stock referred to in § 361(c)(2)(B)(ii) is the stock of the Purchaser in a Type C stock-for-assets reorganization.)

Because boot is permitted in Type A and C reorganizations, § 361(b) – which has been edited out of the excerpt above and won't be covered in class or the exam – deals with the tax consequences to the acquired corporation of its receipt and distribution of boot.

To the Purchaser (P)

Read (in Schwarz & Lathrope)

Pages 325-326

We come finally to the tax consequences to the Purchasing corporation. They are (I hope) what you'd expect them to be. The Purchaser doesn't recognize any gain by exchanging its stock for the stock or assets of another corporation in a Type A, B or C reorganization. But the Purchasing corporation's basis and holding period in the stock or assets that it acquires remains the same as they were in the hands of the shareholders or corporation from which they were acquired.

Here are the Code sections that do this:

§ 1032. Exchange of stock for property

- (a) Nonrecognition of gain or loss. No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. . . .

§ 362. Basis to corporations

-
(b) Transfers to corporations. If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. . . .

§ 1223. Holding period of property

For purposes of this subtitle -

-
(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

Study Guide 24

TRANSFERRING A BUSINESS

Transferring a Corporation's Business

Dividing a Corporation, Tax-Free

Dividing a Corporation, Tax-Free

Mergers and acquisitions are so common that the phrase itself, and its "M&A" abbreviation, are used to identify a legal specialty and even a business magazine. The inverse of mergers and acquisitions – corporate divisions – aren't nearly as glamorous and don't have their own catchphrase or magazine; but they too are common. Not long ago, Time Warner spun off Time Warner Cable, so Time Warner shareholders became shareholders in Time Warner Cable as well. Time Warner had lots of business reasons for the spin-off. And when there are business reasons for spin-offs, Congress is willing to allow them to be tax-free (actually, tax-deferred).

But spin-offs also can be used to make distributions to shareholders that really are dividends, redemptions and liquidations – things that generally are taxable. Congress is not willing to let corporations turn taxable events into tax-free transactions, simply by dressing them in tax-free costumes. Hence, the Code contains standards for testing whether corporate divisions actually qualify for tax-free treatment. And as you can imagine, those standards are very complex.

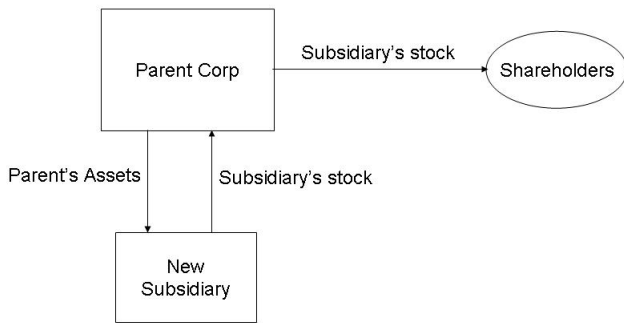
Types of Tax-Free Divisions

As you'll read in the next assignment, there are three types of tax-free divisions:

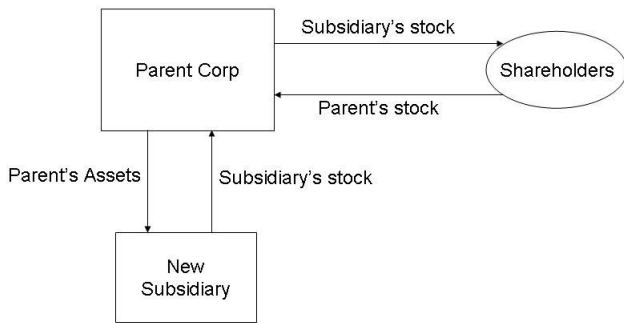
- Spin-Offs (parent corp creates subsidiary, transfers some assets to subsidiary, and distributes subsidiary's stock to parent's shareholders, pro rata, in a transaction that may be a disguised dividend)
- Split-Offs (parent corp creates subsidiary, transfers some assets to subsidiary, and distributes subsidiary's stock to some of parent's shareholders in exchange for their stock in parent, in a transaction that may be a disguised redemption)
- Split-Ups (parent corp creates two subsidiaries, transfers some assets to one and remaining assets to other, and distributes stock in subsidiaries to parent's shareholders in liquidation of parent, in transaction that may be a disguised liquidation)

The charts on the following pages are diagrams of the steps involved in each of these types of divisions.

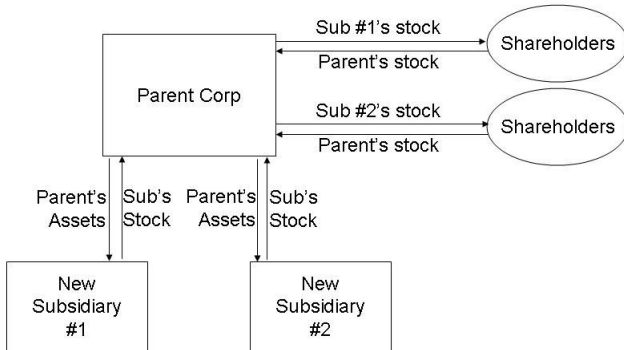
Spin-Off



Split-Off



Split-Up



If these types of corporate divisions don't satisfy the requirements for tax-free treatment, they will be taxable. But all three types of divisions are *eligible* for tax-free treatment; they simply need to satisfy the Code's requirements.

Read (in Schwarz & Lathrope)

Pages 339-340

Requirements for Tax-Free Division

Corporate *divisions* may be "reorganizations" too, just like the mergers and acquisitions we looked at in Study Guide 23. If corporate divisions meet the Code's criteria, they are Type D "reorganizations." Here is the Code section that makes this so:

§ 368. Definitions relating to corporate reorganizations

(a) Reorganization

(1) In general. . . . the term "reorganization" means –

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section . . . 355. . . .

As you can see, § 368(a)(a)(D) appears to have just two requirements:

- At least one shareholder of the pre-division corporation must be "in control" of the corporation to which assets are transferred in the division. This requirement simply prevents a corporation from selling assets, tax-free, to a company that's owned by someone else; that sort of sale is supposed to be taxable.
- Stock in the company to which assets are transferred must be distributed "in a transaction that qualifies under section . . . 355. . . ." This requirement doesn't mean anything on its face, because it requires you to go to § 355 to see what *it* requires. And when you do, you find that § 355 imposes *many* more requirements – though you'll also see (below) that it's the last few lines of § 355(a)(1) that actually make Type D reorganizations tax-free.

Read (in Schwarz & Lathrope)

Pages 340-342

§ 355. Distribution of stock and securities of a controlled corporation

(a) Effect on distributees

(1) General rule. If -

(A) a corporation (referred to in this section as the "distributing corporation") -

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied [i.e., the distributing corporation and the controlled corporation are actively in business after the distribution], and

(D) as part of the distribution, the distributing corporation distributes -

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control . . . , and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities. (Emphasis added)

The requirements of § 355 do not look (to me) to be difficult to satisfy for small, closely-held corporations (like the one owned by Anne, Beth, Carl and Doug). However, in addition to the requirements of Code § 355, there is one more requirement – one that was first created by judicial decisions, and has since been incorporated into a Treasury Regulation. The additional requirement is that the corporate division have a "business purpose" that is "independent" of tax savings. The "Independent Business Purpose" Regulation follows. (Read its Examples carefully.) This requirement looks (to me) like one that a small, closely-held corporation could trip over – even where the division was not primarily intended to avoid taxes.

Reg. § 1.355-2(b) Independent business purpose—

(1) *Independent business purpose requirement.* Section 355 applies to a transaction only if it is carried out for one or more corporate business purposes.... The principal reason for this business purpose requirement is to provide nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms. This business purpose requirement is independent of the other requirements under section 355.

(2) *Corporate business purpose.* A corporate business purpose is a real and substantial non Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group . . . to which the distributing corporation belongs. . . . A shareholder purpose (for example, the personal planning purposes of a shareholder) is not a corporate business purpose. Depending upon the facts of a particular case, however, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. In such a case, the transaction is carried out for one or more corporate business purposes. See Example (2) of paragraph (b)(5) of this section.

(3) *Business purpose for distribution.* The distribution must be carried out for one or more corporate business purposes. See Example (3) of paragraph (b)(5) of this section. If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive, then, for purposes of paragraph (b)(1) of this section, the separation is not carried out for that corporate business purpose. See Examples (3) and (4) of paragraph (b)(5) of this section. . . .

(5) *Examples.* The provisions of this paragraph (b) may be illustrated by the following examples:

Example (1). Corporation X is engaged in the production, transportation, and refining of petroleum products. In 1985, X acquires all of the properties of corporation Z, which is also engaged in the production, transportation, and refining of petroleum products. In 1991, as a result of antitrust litigation, X is ordered to divest itself of all of the properties acquired from Z. X transfers those properties to new corporation Y and distributes the stock of Y pro rata to X's shareholders. In view of the divestiture order, the distribution is carried out for a corporate business purpose. See paragraph (b)(1) of this section.

Example (2). Corporation X is engaged in two businesses: The manufacture and sale of furniture and the sale of jewelry. The businesses are of equal value. The outstanding stock of X is owned equally by unrelated individuals A and B. A is more interested in the furniture business, while B is more interested in the jewelry business. A and B decide to split up the businesses and go their separate ways. A and B anticipate that the operations of each business will be enhanced by the separation because each shareholder will be able to devote his undivided attention to the business in which he is more interested and more proficient. Accordingly, X transfers the jewelry business to new corporation Y and distributes the stock of Y to B in exchange for all of B's stock in X. The distribution is carried out for a corporate business purpose, notwithstanding that it is also carried out in part for shareholder purposes. See paragraph (b)(2) of this section.

Example (3). Corporation X is engaged in the manufacture and sale of toys and the manufacture and sale of candy. The shareholders of X wish to protect the candy business from the risks and vicissitudes of the toy business. Accordingly, X transfers the toy business to new corporation Y and distributes the stock of Y to X's shareholders. Under applicable law, the purpose of protecting the candy business from the risks and vicissitudes of the toy business is achieved as soon as X transfers the toy business to Y. Therefore, the distribution is not carried out for a corporate business purpose. See paragraph (b)(3) of this section.

Questions re Requirements for Tax-Free Division

1. The deal to acquire the corporation owned by Anne, Beth, Carl and Doug for \$20 million (which we covered in Study Guide 23) fell apart, for reasons that would make up the first installment of a TV mini-series. Losing the deal put a strain on the relationships among the four shareholders. After more than five years as co-owners of the corporation, they decided they had to go in two separate ways. From its start, the corporation's business has involved: (a) manufacturing clothes; and (b) selling them in company-owned retail stores. Carl and Doug managed the manufacturing, and Anne and Beth managed the retail stores. The manufacturing part of the business is worth the same amount as the retail part. Before the \$20 million acquisition fell through, Anne and Beth didn't interfere with Carl and Doug; and Carl and Doug didn't interfere with Anne and Beth. Now, though, as a result of the strain on their relationships, Anne and Beth are interfering with Carl and Doug's end of the business, and vice versa. The four of them have decided that both sides of their corporation's business would do better, if they divided the corporation into separate companies – one owned *only* by Anne and Beth, and the other owned *only* by Carl and Doug. There are at least three ways this could be done: as a "spin-off," a "split-off" or a "split-up." Which of the three could be used to do it "tax-free"? (Circle all that would be tax-free.)
 - a. *Spin-off*. The corporation could: create a subsidiary; transfer the assets of the retail business to the subsidiary (in exchange for stock in the subsidiary); distribute the subsidiary's stock, pro rata, to each of the four shareholders; Anne and Beth then could sell their stock in the original corporation to Carl and Doug for \$5 million each; Carl and Doug could sell their stock in the subsidiary to Anne and Beth for \$5 million each. (Since the amounts are the same, they wouldn't even have to cash the checks!)
 - b. *Split-off*. The corporation could: create a subsidiary; transfer the assets of the retail business to the subsidiary (in exchange for stock in the subsidiary); and then transfer the stock of the subsidiary to Anne and Beth in exchange for their stock in the original corporation.
 - c. *Split-up*. The corporation could: create two subsidiaries; transfer the manufacturing assets to one and transfer the retail assets to the other (in exchange for stock in each subsidiary); and distribute the stock of the manufacturing subsidiary to Carl and Doug and the stock of the retail subsidiary to Anne and Beth, in liquidation of the original corporation.
 - d. Both "b" and "c".

2. The \$20 million deal to acquire the corporation owned by Anne, Beth, Carl and Doug fell apart, because of the weakened economy. Losing the deal was a disappointment, but the four shareholders remained compatible business associates, and they decided to carry on together. From its start, the corporation's business has involved: (a) producing movies, which is a very risky business; and (b) operating a movie theater, which is a remarkably stable business. The producing part of the business is worth the same amount as the theater part. The shareholders would like to protect their corporation's theater business from the financial risks of its producing business. Which of the following methods for dividing the company can be used to do it "tax-free"? (Circle all that would be tax-free.)
- The corporation could: create a subsidiary; transfer the assets of the production business to the subsidiary (in exchange for stock in the subsidiary); and then distribute the subsidiary's stock, pro rata, to each of the four shareholders.
 - The corporation could: create a subsidiary; transfer the assets of the production business to the subsidiary (in exchange for stock in the subsidiary); and then transfer the stock of the subsidiary to the four shareholders, pro rata, in exchange for half of their stock in the original (now parent) corporation.
 - The corporation could: create two subsidiaries; transfer the movie production assets to one and transfer the movie theater assets to the other (in exchange for stock in each subsidiary); and distribute the stock of both subsidiaries to the four shareholders, pro rata, in liquidation of the original corporation.
 - None of the above.

Tax Treatment of Tax-Free Divisions

Now that you know what kinds of corporate divisions qualify as tax-free, you need to know what, exactly, "tax-free" means. This is a two-part question, because it means something to *shareholders* who receive stock distributions, and it also means something to the *corporation* that makes the distribution.

To Shareholders

Insofar as shareholders are concerned, Type D reorganizations are referred to as "tax-free" because of this language in § 355:

§ 355. Distribution of stock and securities of a controlled corporation

(a) Effect on distributees

(1) General rule. If -

(A) a corporation (referred to in this section as the "distributing corporation") -

. . . distributes to a shareholder . . .

solely stock . . . of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder . . . on the receipt of such stock. . . .

“Tax-free” isn’t really the right phrase, though. “Tax-deferred” would be more accurate, because of this Code section:

§ 358. Basis to distributees

- (a) General rule. In the case of an exchange to which section . . . 355 . . . applies -
- (1) Nonrecognition property. The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged. . . .

The specific language of § 358(a)(1) makes perfect sense if the division is a

- split-off, where shareholders receive stock in the “split-off” corporation in exchange for their stock in the distributing corporation, or
 - split-up, where shareholders receive stock in one or both of the corporations created by the division, and the original corporation is then liquidated,
- because in both types of divisions, shareholders receive and give up stock.

The specific language of § 358(a)(1) doesn’t make perfect sense if the division is a spin-off, because in that sort of division, shareholders receive stock in the spun-off corporation without giving up any of the stock in the distributing corporation. But, as the next reading assignment explains, §358(a)(1)’s carry-over-of-basis requirement is satisfied in spin-offs simply by having shareholders apportion their pre-spin-off basis in the the stock of the distributing corporation between (a) the stock they receive in the spun-off corporation and (b) the stock they continue to own in the distributing corporation, in proportion to the post-spin-off values of the two corporations.

Read (in Schwarz & Lathrope)

Pages 358-360

To Distributing Corporation

Read (in Schwarz & Lathrope)

Pages 360-362

Here are the Code sections that make Type D reorganizations tax-deferred to the distributing corporation too.

§ 361. Nonrecognition of gain or loss to corporations; treatment of distributions

(a) General rule. No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

. . .

(c) Treatment of distributions

(1) In general. . . . no gain or loss shall be recognized to a corporation a party to a reorganization on the distribution to its shareholders of property in pursuance of the plan of reorganization.

§ 362. Basis to corporations

. . .

(b) Transfers to corporations. If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. . . .

Questions re Tax Treatment of Tax-Free Divisions

3. The deal to acquire the corporation owned by Anne, Beth, Carl and Doug for \$20 million fell apart. Losing the deal put a strain on the relationships among the four shareholders. After more than five years as co-owners of the corporation, they decided they had to go in two separate ways. From its start, the corporation's business has involved: (a) manufacturing clothes; and (b) selling them at retail in company-owned stores. Carl and Doug managed the manufacturing, and Anne and Beth managed the retail stores. The manufacturing part of the business is worth the same amount as the retail part. Before the \$20 million acquisition fell through, Anne and Beth didn't interfere with Carl and Doug; and Carl and Doug didn't interfere with Anne and Beth. Now, though, as a result of the strain on their relationships, Anne and Beth are interfering with Carl and Doug's end of the business, and vice versa. The four of them have decided that both sides of their corporation's business would do better now, if they divided the corporation into separate companies – one owned only by Anne and Beth, and the other owned only by Carl and Doug. To accomplish this, the corporation created a subsidiary; transferred the assets of the retail business to the subsidiary (in exchange for stock in the subsidiary); and then transferred the stock of the subsidiary to Anne and Beth in exchange for their stock in the original corporation. What were the tax consequences to Anne and Beth, if
- the fair market value of the stock they *each* received is \$5 million each,
 - Anne's basis in the stock of the original corporation is \$100,000, and
 - Beth's basis in the stock of the original corporation is \$50,000?
- a. Anne will have a taxable gain of \$4,900,000; and Beth will have a taxable gain of \$4,950,000.
 - b. Neither will have a taxable gain immediately. But Anne's basis in her new stock will be \$4,900,000, so if she eventually sells it for \$5,000,000, she'll have a \$100,000 taxable gain at that time; and Beth's basis in her new stock will be \$4,950,000, so if she eventually sells it for \$5,000,000, she'll have a \$50,000 taxable gain at that time.
 - c. Neither will have a taxable gain immediately. But Anne's basis in her new stock will be \$100,000, so if she eventually sells it for \$5,000,000, she'll have a \$4,900,000 taxable gain at that time; and Beth's basis in her new stock will be \$50,000, so if she eventually sells it for \$5,000,000, she'll have a \$4,950,000 taxable gain at that time.

Study Guide 25

ENDING A BUSINESS

Liquidating a Partnership

Going Out of Business

Making Major Changes in the Ownership of the Partnership's Business

ENDING A BUSINESS

As we approach the end of the semester, we come to the tax consequences of ending a business. In this Study Guide, we'll look at partnerships, and in the next, at corporations.

Liquidating a Partnership

"Ending" is an everyday term, not a legal one. The legal term for what we'll be covering now is "liquidating." You'll recall that in Study Guide 18, we looked at the tax consequences of "liquidating a partner's interest" in a partnership; but in that Study Guide, the word "liquidating" was used to describe the acquisition of the interest of a departing partner by a partnership that was going to *continue* to exist. Now, we'll look at the acquisition of the interests of all partners by a partnership that is going to *cease* to exist.

A partnership may cease to exist in two different ways.

- It may go out business entirely.
or
- It may make such a major change in its ownership that it is deemed to have been "liquidated" as a matter of law, even though its business is being carried on by new owners.

Going Out of Business

Read (in Schwarz & Lathrope)

Pages 590 (paragraph B.1.a. only)

When a partnership is liquidated because it's going out of business entirely, the partnership shuts down its business operations completely, pays its creditors, distributes its remaining assets to its partners, and ceases to exist. This may be done in either of two ways:

- The partnership itself may sell all of its assets for cash, thereby realizing profits or losses which it allocates to the partners in the manner you learned in Study Guides 6 and 7, and distributes the cash to its partners with the tax consequences discussed below.
- The partnership may distribute its assets (including cash, if it has some) to the partners, so the partners themselves can sell those assets (if they want to) with the tax consequences discussed below.

The *general* rules concerning the tax consequences of this kind of liquidation are easy:

- Neither the partners nor the partnership realize a gain or loss on the distribution of the partnership's *non-cash* assets.
- If *cash* is distributed, and the amount exceeds the partner's basis in the partnership, the excess is income.

The cash-may-be-income part of the rule should sound familiar to you, because it's the same rule we saw in Study Guide 10 concerning distributions to partners by an on-going partnership. In fact, the Code section that spells out this general rule is the same section we covered in Study Guide 10:

§ 731. Extent of recognition of gain or loss on distribution

- (a) Partners. In the case of a distribution by a partnership to a partner -
 - (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and
 - (2) loss shall not be recognized to such partner. . . .
- (b) Partnerships. No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.

By this point in the semester, you no doubt suspect that although partners do not recognize gain on their receipt of non-cash assets when a partnership is liquidated, this does not make those assets tax-free forever. It simply postpones the day of tax-reckoning until the by-then ex-partners sell those assets. The device by which the Treasury captures the gain (or permits a loss) at that time is the now-familiar carry-over-of-basis rule. Here it is:

§ 732. Basis of distributed property other than money

-
- (b) Distributions in liquidation. The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

A special rule is necessary if a partnership distributes *unrealized receivables* or *inventory* to its partners. Receivables and inventory are not "money," so § 731(a), *by itself*, would not require partners to recognize gain when receivables or inventory are distributed in a partnership liquidation. Under § 732(b), *by itself*, partners to whom receivables or inventory are distributed would take them with a basis pegged to the partners' own basis in the liquidated partnership; but having a basis in receivables and inventory implies that they are capital assets, and that implies that when the partners eventually collect the receivables or sell the inventory, they would pay tax at capital gains rates. Neither of those results could be the law, because receivables and inventory would have produced ordinary income to the partnership, if the partnership had stayed in business long enough to collect the receivables and sell the inventory itself. And the law doesn't permit liquidations to be used to transmute ordinary income into capital gains.

Here's how the law does handle unrealized receivables and inventory:

§ 735. Character of gain or loss on disposition of distributed property

- (a) Sale or exchange of certain distributed property
 - (1) Unrealized receivables. Gain or loss on the disposition by a distributee partner of unrealized receivables . . . distributed by a partnership, shall be considered as ordinary income or as ordinary loss, as the case may be.
 - (2) Inventory items. Gain or loss on the sale or exchange by a distributee partner of inventory items . . . distributed by a partnership shall, if sold or exchanged within 5 years from the date of the distribution, be considered as ordinary income or as ordinary loss, as the case may be.

If a partnership distributes assets that really are capital assets, their eventual sale by the then-ex-partners will be taxed at capital gains rates. So partners who receive such assets need to know what their holding period is, in order to know whether to pay tax at long-term or short-term rates. Here's the Code section that answers that question:

§ 735. Character of gain or loss on disposition of distributed property

- . . .
 - (b) Holding period for distributed property. In determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of subsection (a)(2) [just above, concerning inventory]), there shall be included the holding period of the partnership . . . with respect to such property.

One last point: If you are particularly imaginative (a good thing for a tax lawyer to be), it may have occurred to you that the difference between the tax treatment of (i) unrealized receivables and inventory, and (ii) capital assets, presents a planning opportunity for partners whose partnership is about to be liquidated. For example, some partners may be better able than others to absorb the impact of the *ordinary income* treatment given to receivables and inventory; and thus some partners may be willing to trade what otherwise would have been their shares of capital assets to partners who would prefer capital assets, in return for more than what would have been their shares of receivables and inventory, *plus* (presumably) something else of value. It's a clever plan, but the Code doesn't permit it:

§ 751. Unrealized receivables and inventory items

...

- (b) Certain distributions treated as sales or exchanges
 - (1) General rule. *To the extent* a partner receives in a distribution -
 - (A) partnership property which is -
 - (i) unrealized receivables, or
 - (ii) inventory items which have appreciated substantially in value, *in exchange for all or a part of his interest in other partnership property (including money), or*
 - (B) partnership property (including money) other than property described in subparagraph (A)(i) or (ii) *in exchange for all or a part of his interest in partnership property described in subparagraph (A)(i) or (ii),* such transactions shall . . . be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

[Emphasis added.]

In plain English, § 751(b) treats the *portion* ("To the extent") of receivables and inventory *exchanged* for capital assets, and vice versa, as having been *sold* to the partnership. Because it's treated as a sale, any gain will be taxed at: ordinary income rates to partners who give up some of their receivables or inventory; and capital gains rates to partners who give up some of their capital assets.

Questions re Liquidating a Partnership

Anne, Beth, Carl and Doug have been partners for many years, and now they would like to sell their partnership. They haven't yet been able to find a buyer for the entire business, so they are thinking about liquidating the partnership and distributing its assets, equally, among the four of them. Before they do that, though, they want to know what the tax consequences to them will be.

Here are the partnership's current assets, their fair market values, and the partnership's basis in those assets:

	FMV	Basis
Cash	\$200,000	\$ 0
Capital Assets	\$100,000	\$ 50,000
Accounts Receivable	\$100,000	\$ 0
Inventory	<u>\$100,000</u>	<u>\$ 75,000</u>
Totals	\$500,000	\$125,000

Here are the four partners' capital accounts and bases in their partnership interests:

	Cap Accts	Basis
Anne	\$125,000	\$100,000
Beth	\$125,000	\$ 50,000
Carl	\$125,000	\$ 25,000
Doug	<u>\$125,000</u>	<u>\$100,000</u>
Totals	\$500,000	\$275,000

Assume the partnership distributes the following assets to *each* partner:

	FMV	Basis
Cash	\$ 50,000	\$ 0
Capital Assets	\$ 25,000	\$12,500 (i.e., 25% of partnership's basis)
Accounts Receivable	\$ 25,000	\$ 0
Inventory	<u>\$ 25,000</u>	<u>\$18,750</u> (i.e., 25% of partnership's basis)
Totals	\$125,000	\$31,250

1. What will the tax consequences be to the *partnership* itself?
 - a. There will be no tax consequences to the partnership, ever.
 - b. The partnership will realize a total gain of \$375,000 (\$500,000 - \$125,000), resulting in \$93,750 in taxable income to each of the partners (25% of \$375,000).
2. What will the tax consequences be to each of the partners?
 - a. There will be no tax consequences to any of the partners, ever.
 - b. Each partner will have \$93,750 in taxable income (\$125,000 - \$31,250).
 - c. There will be no immediate tax consequences to any partner immediately, but each partner's basis in the assets he or she receives will be the same as the partnership's basis in those assets, so if a partner sells any of the assets, he or she will recognize a gain (or loss) at that time.
 - d. The tax consequences to the partners will be different, because their bases *in the partnership* are different, and the tax consequences to each partner depend on each partner's basis *in the partnership*.

If your answer to Question 2 was "a," "b" or "c", go on to page 7 of this Study Guide. If your answer to Question 2 was "d," answer Questions 3, 4 and 5 below.

3. What will the tax consequences be to Anne?

- a. There will be no tax consequences to Anne.
- b. Anne will not have any income on account of the distribution to her of \$50,000 in cash, but she will have ordinary income of \$25,000 immediately on account of the distribution to her of unrealized receivables, and she will have ordinary income of \$25,000 immediately on account of the distribution to her of inventory; and her basis in the Capital Assets distributed to her will be \$12,500.

- c. Anne will not have any income on account of the distribution to her of \$50,000 in cash, but her basis in the other assets will be reduced by \$50,000, *from* her \$100,000 basis in the partnership to \$50,000, allocated this way:

Capital Assets	\$16,667
Accounts Receivable	\$16,667
Inventory	<u>\$16,666</u>
Total	\$50,000

So when she sells the capital assets, she will have a capital gain (if she sells them for their current FMV) of \$8,333 at that time. And when she collects the Accounts Receivable (if she collects all \$25,000), she will have ordinary income of \$8,333 at that time. And when she sells the inventory (if she sells it for its current FMV), she will have ordinary income of \$8,334 at that time.

- d. Anne will not have any income on account of the distribution to her \$50,000 in cash, but her basis in the other assets will be reduced by \$50,000, *from* her \$100,000 basis in the partnership to \$50,000, allocated this way:

Capital Assets	\$16,667
Accounts Receivable	\$16,667
Inventory	<u>\$16,666</u>
Total	\$50,000

So, she will immediately have ordinary income \$8,333 from the allocation to her of \$25,000 in accounts receivable. And she will immediately have ordinary income of \$8,334 from the allocation to her of \$25,000 in inventory. And when she sells the capital assets, she will have a capital gain (if she sells them for their current FMV) of \$8,333 at that time.

4. What will the tax consequences be to Carl?

- a. There will be no tax consequences to Carl.
- b. Carl will not have any income on account of the distribution to him of \$50,000 in cash, but he will have ordinary income of \$25,000 immediately on account of the distribution to him of unrealized receivables, and he will have ordinary income of \$25,000 immediately on account of the distribution to him of inventory; and his basis in the Capital Assets distributed to him will be \$12,500.
- c. Carl will not have any income on account of the distribution to him of \$50,000 in cash, but his basis in the other assets will be reduced by \$50,000, from his \$25,000 capital account in the partnership to -\$25,000, allocated this way:

Capital Assets	-\$8,333
Accounts Receivable	-\$8,333
Inventory	<u>-\$8,334</u>
Total	-\$25,000

So when he sells the capital assets, he will have a capital gain (if he sells them for their current FMV) of \$33,333 at that time. And when he collects the Accounts Receivable (if he collects all \$25,000), he will have ordinary income of \$33,333 at that time. And when he sells the inventory (if he sells it for its current FMV), he will have ordinary income of \$33,334 at that time.

- d. Carl will have a \$25,000 capital gain immediately, on account of the distribution to him of \$50,000 in cash (\$50,000 - \$25,000 (his basis in the partnership)), and his basis in the assets distributed to him will be \$0 (i.e., his \$25,000 basis in the partnership - \$50,000 in cash distributed to him + \$25,000 in gain recognized immediately). So when he sells the capital assets, he will have a capital gain (if he sells them for their current FMV) of \$25,000 at that time. And when he collects the Accounts Receivable (if he collects all \$25,000), he will have ordinary income of \$25,000 at that time. And when he sells the inventory (if he sells it for its current FMV), he will have ordinary income of \$25,000 at that time.

5. If your answer to Question 3 was "c" and your answer to Question 4 was "d," did you notice that

- Anne's total taxable gain was \$25,000, which is the exact difference between her \$100,000 basis in the partnership and the \$125,000 in cash and assets distributed to her, and
- Carl's total taxable gain was \$100,000, which is the exact difference between his \$25,000 basis in the partnership and the \$125,000 in cash and assets distributed to him,

and the rest of the exercise simply concerned

- when they would have to pay tax on their gains, and
- what portions of their gains would be taxed at capital gains rates and what portions would be taxed at ordinary income rates?

- a. Yes, I saw that immediately.
- b. No, I didn't see it before, but I see it now.
- c. No, I didn't see it before, and I still don't see it.
- d. I see it, or don't, but in either event: so what?

Making Major Changes in the Ownership of the Partnership's Business

The next reading assignments deal with four sets of circumstances that don't really involve the end of a partnership's *business*. Instead, they involve the end of a *partnership* whose business is carried on by others. These circumstances are:

- the incorporation of a partnership,
- the merger of a partnership into another partnership, or the consolidation of two partnerships into a new partnership,
- the division of a partnership into two partnerships, and
- the automatic "termination" of a partnership as a result of the sale of half or more of the interests in the partnership.

The tax issues that arise out of these four sets of circumstances actually fit, more logically, earlier in this course.

- The *incorporation* topic logically fits between Study Guides 21 and 22, in what should have been its own section titled "Transferring a Partnership's Business," under the subtitle "Transferring a Partnership's Assets," because that's what happens when a partnership is incorporated: it's assets are transferred to a new corporation.
- The *automatic termination* topic would logically come next, also under the subtitle "Transferring a Partnership's Assets," because that's what happens when a partnership is terminated as a result of the sale of half or more of its interests: it's assets are transferred to a new partnership.
- The *merger or consolidation* topic would logically come next, under the subtitle "Reorganizing a Partnership," because partnership mergers and consolidations are analogous to Type A corporate reorganizations.
- The *division* topic would come next, under the subtitle "Dividing a Partnership," because partnership divisions are analogous to Type D corporate reorganizations.

The reason these topics were not covered earlier is that in order to understand the law that addresses these issues, it's first necessary to be familiar with the tax consequences of a going-out-of-business liquidation (i.e., the issues that were covered just above). This is so, because it is possible and permissible for a partnership to voluntarily liquidate itself and distribute its assets to its partners, as though it were going out of business, as the first step in doing any of the four things outlined above. That is, the partners could take the assets they receive in such a liquidation and use them to incorporate or form new partnerships. The question to be considered now is whether tax-wise, liquidating and using the distributed assets to incorporate or form new partnerships is the best thing to do, or whether there's something else the law allows partners to do that's even better.

Incorporating a Partnership

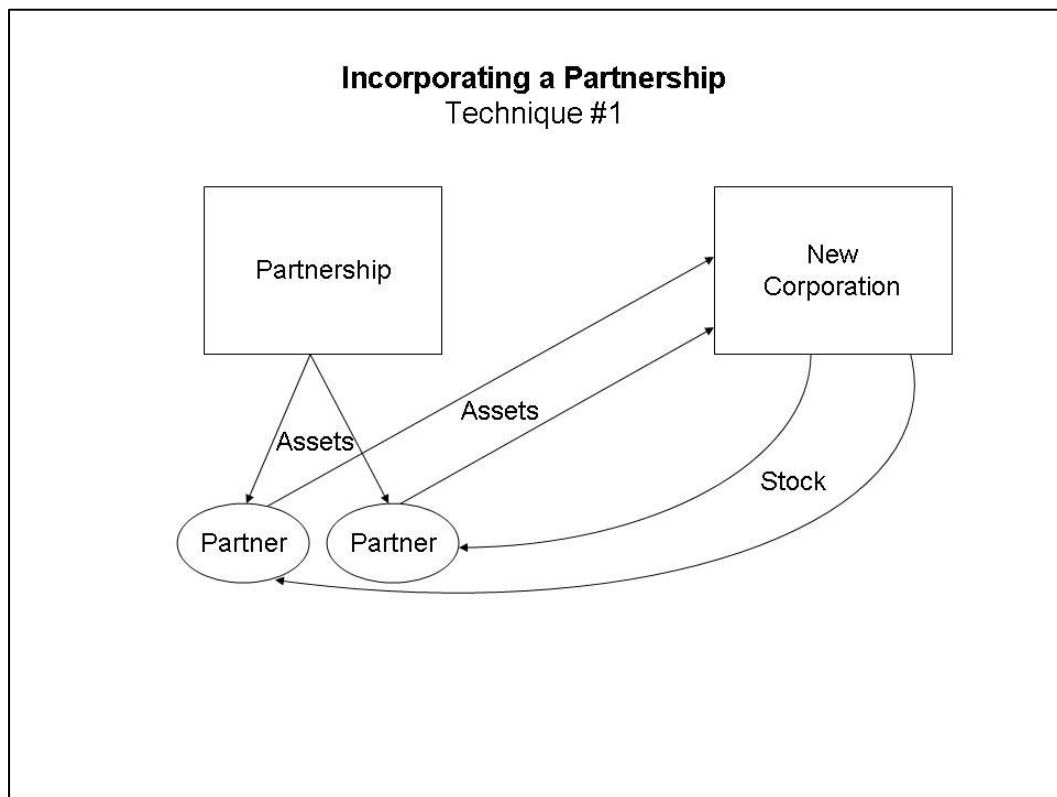
Read (in Schwarz & Lathrope)

Pages 590 (paragraph B.1.b.) - 591

There are three ways a partnership may be incorporated:

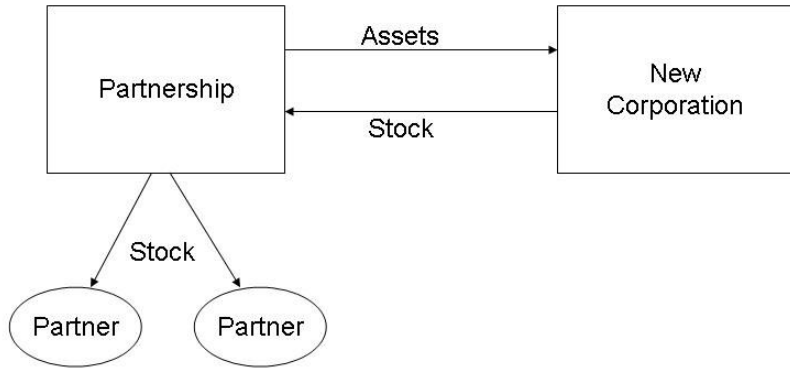
1. The *partnership* may liquidate and distribute its assets to its partners (with the tax consequences outlined earlier in this Study Guide) and the *partners* may contribute those assets to a newly-formed corporation in exchange for its stock (with the tax consequences outlined in Study Guides 3 and 4).
2. The *partnership* itself may transfer its assets to a newly-formed corporation in exchange for its stock (with the consequences outlined in Study Guides 3 and 4), and then distribute the stock to its partners in a liquidation (with the consequences outlined earlier in this Study Guide).
3. The *partners* may transfer their interests in the partnership to the corporation in exchange for its stock (with the consequences outlined in this Study Guide below, resulting from the exchange of more than half the partnership's interests).

Here are diagrams, illustrating the differences between these partnership-incorporation techniques:



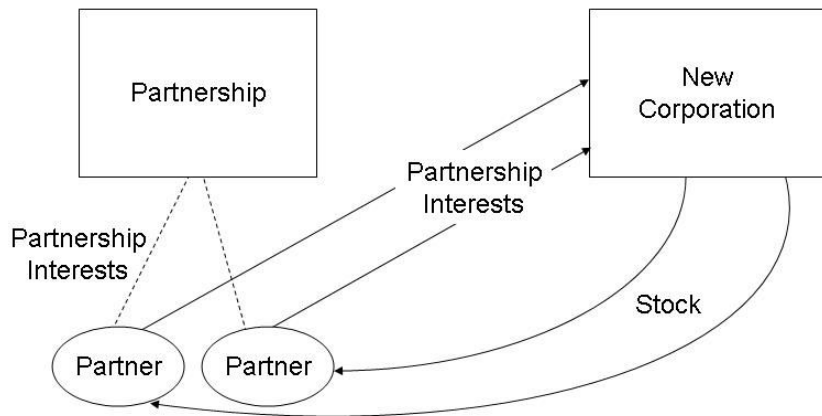
Incorporating a Partnership

Technique #2



Incorporating a Partnership

Technique #3



The tax consequences of incorporating a partnership one way will differ from doing it another way, *if*:

- there is a difference between the partnership's inside basis in its assets, and the partners' outside basis in their partnership interests, or
- there is a difference between the partnership's holding period in its assets, and the partners' holding period in their partnership interests.

(It may make a difference too for other reasons I haven't been able to think of.)

Merging or Consolidating Partnerships

Read (in Schwarz & Lathrope)

Pages 591-592

If one partnership is merged into or consolidated with another, the new partnership is considered to be a continuation of one of the original partnerships, and the other original partnership is treated as having been terminated. The Code spells out which partnership is the continuing one, and that makes the other partnership the terminated one.

§ 708. Continuation of partnership

(a) General rule. For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

. . .

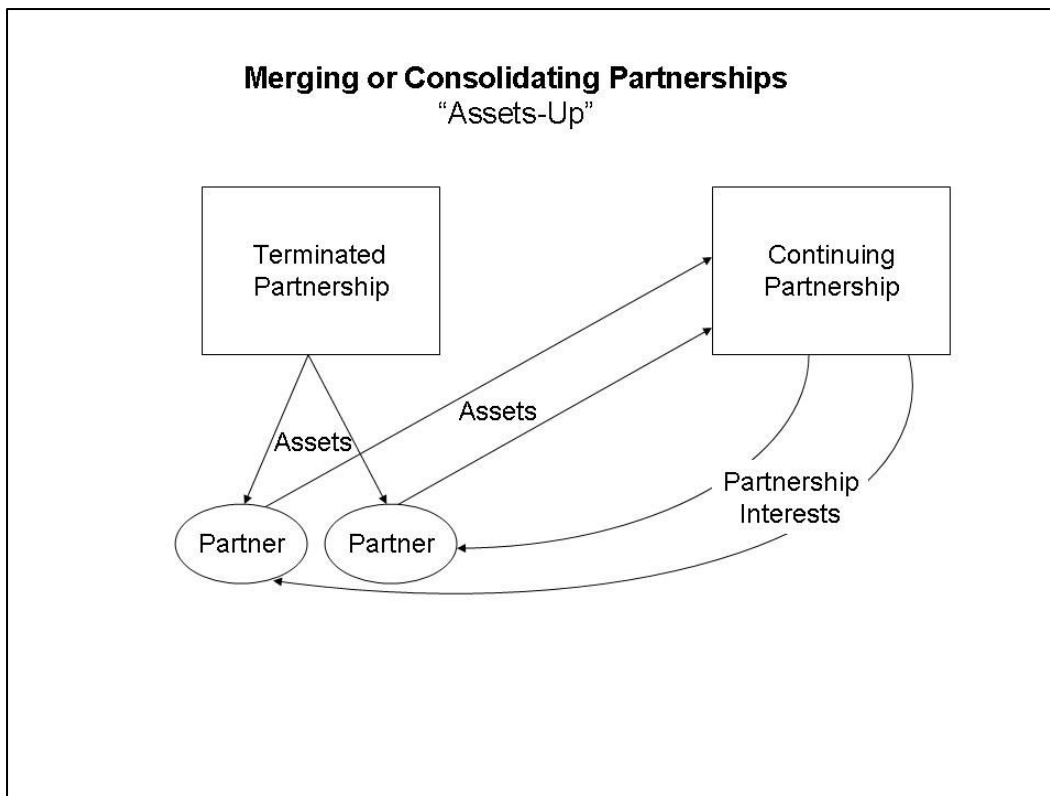
(2) Special rules

(A) Merger or consolidation. In the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

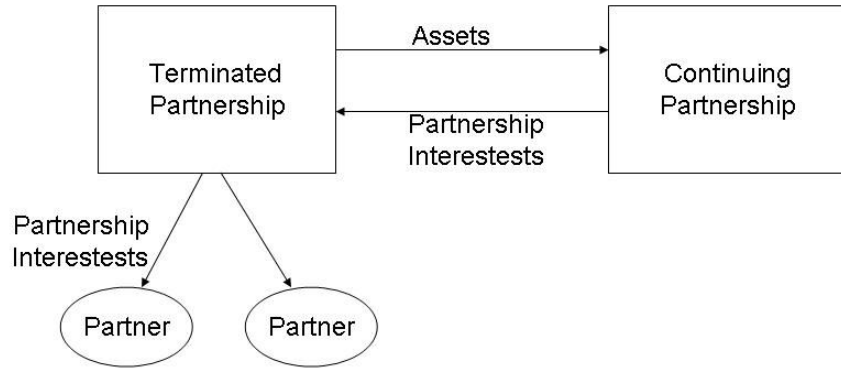
The partners in the partnership that's terminated are permitted to handle the termination in any of three ways that parallel the options (described above) that are available to partnerships that are incorporated. The Regulations give each of these three forms a nickname:

1. *assets-up* = the distribution of the terminated partnership's assets to its partners who contribute them to the continuing partnership in exchange for interests in the continuing partnership (i.e., partners transfer the *assets* they receive from the terminated partnership *up* to the continuing partnership)
2. *assets-over* = the terminated partnership's contribution of its assets to the continued partnership in exchange for interests in the continuing partnership, followed by the liquidation of the terminated partnership and the distribution of the partnership interests in the continuing partnership to the terminated partnership's partners (i.e., the terminated partnership transfers its *assets over* to the continuing partnership)
3. *interests-over* = the terminated partnership's partners transfer their interests in the terminated partnership to the continuing partnership in exchange for interests in the continuing partnership (i.e., partners transfer their *interests* in the terminated partnership *over* to the continuing partnership)

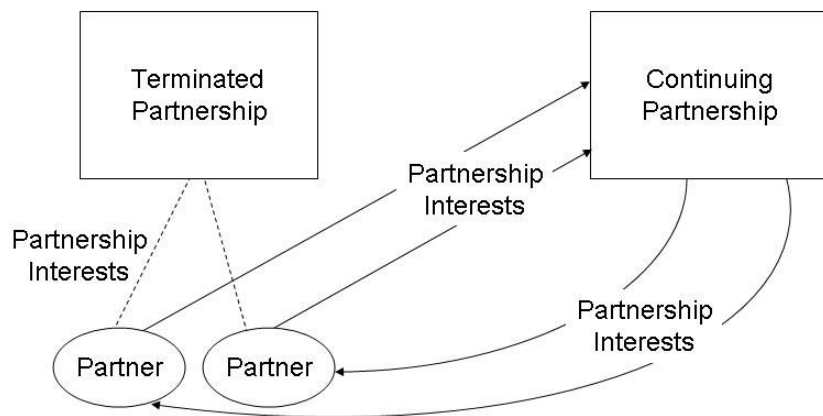
Here are diagrams, illustrating the differences between these partnership-merging or consolidating techniques:



Merging or Consolidating Partnerships
"Assets-Over"



Merging or Consolidating Partnerships
"Interests-Over"



The tax consequences of merging or consolidating partnerships one way will differ from doing it another way, if:

- the partners' outside bases in the terminating partnership are not the same as the terminating partnership's inside basis in its assets,

because:

- in an assets-over transaction, the continuing partnership's basis in the acquired assets will be the same as the terminating partnership's basis in those assets (Code § 723, Study Guide 2 at pg 3),

but

- in an assets-up transaction, the basis of the terminating partnership's assets will be determined when those assets are distributed to the partners, which means their bases may be different than they were in the hands of partnership (Code § 732, Study Guide 10 at pg 5); and the continuing partnership's basis in those assets will be the same as their bases in the hands of the partners that contributed them.

Dividing a Partnership

Read (in Schwarz & Lathrope)

Pages 592-593

If one partnership is divided into two or more partnerships, one is considered to be a continuation of the original partnership, and the others are considered to be new partnerships. The Code spells out which partnership is the continuing one, and that makes the other partnership the new one. Here's the Code section that specifies which is which:

§ 708. Continuation of partnership

(a) General rule. For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

(b) Termination

...

(2) Special rules

...

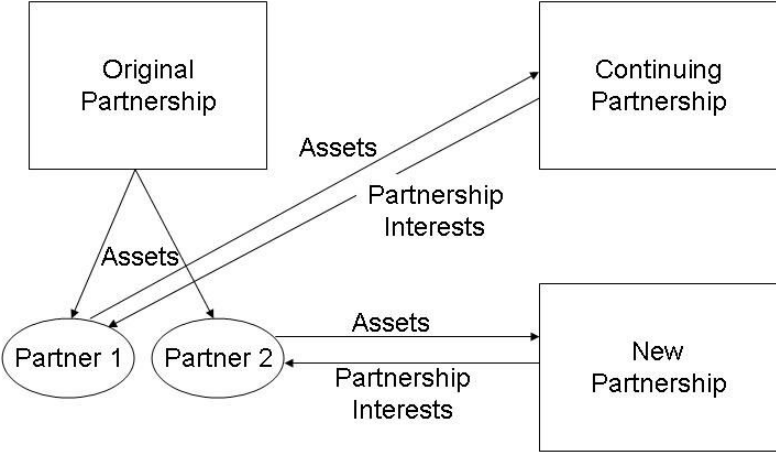
(B) Division of a partnership. In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) shall, for purposes of this section, be considered a continuation of the prior partnership.

Partnerships may be divided using the assets-up or the assets-over method. Doing it one way, rather than the other, may matter for the same reason it may matter in connection with partnership mergers and consolidations – namely, the impact on the new partnership's basis in the assets contributed to it, *if* the terminating partnership's inside basis in those assets was different than the partners' outside basis in their partnership interests.

Here are diagrams, illustrating the differences between these techniques for dividing partnerships:

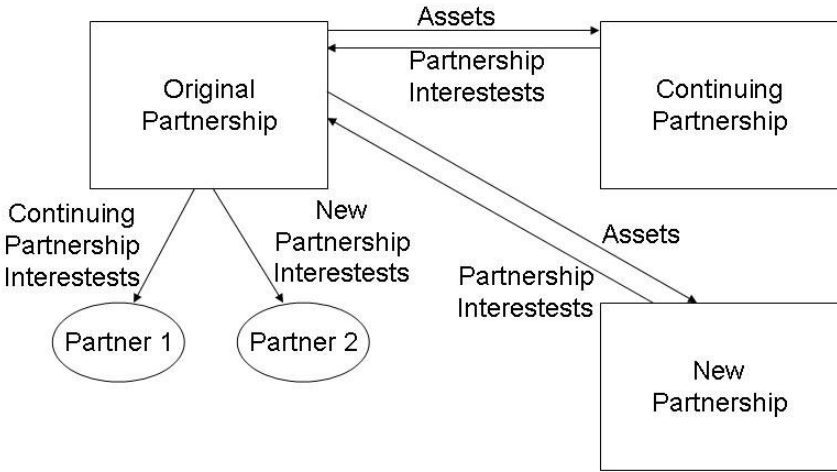
Dividing Partnerships

“Assets-Up”



Dividing Partnerships

“Assets-Over”



Terminating a Partnership by Selling Half or More of its Interests

If half or more of the interests in a partnership are sold or exchanged within 12 months, the partnership is terminated, automatically, by operation of the following law:

§ 708. Continuation of partnership

- (a) General rule. For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.
- (b) Termination
 - (1) General rule. For purposes of subsection (a), a partnership shall be considered as terminated . . . if -
 - . . .
 - (B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

Here's what happens if a partnership is terminated by virtue of § 708(b)(1)(B):

Reg. § 1.708-1 Continuation of partnership

- (b) Termination—
 - (4) If a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership. . . .

As the next reading assignment explains (at least, tries to), the consequence of Reg. §1.708-1 is that the capital accounts of the partners in the old partnership carry over to the new partnership. You first met "capital accounts" back in Study Guide 7 where you learned that a partner's capital account represents his or her share (stated in dollars) of the value of the partnership's assets. And, unless the terminated partnership made a § 754 election, that partnership's basis in its assets will carry over to the new partnership too.

Read (in Schwarz & Lathrope)

Pages 593-596

Question re Making Major Changes in the Ownership of the Partnership's Business

5. There are several different ways to liquidate a partnership, but as a *general* rule, *all* of them will produce the *same* tax consequences:
- no *immediate* gain or loss will realized by the partnership, and
 - no gain or loss will by realized by the partners (except to the extent cash is distributed in an amount that exceeds a partner's basis in the partnership); but
 - each partner's basis (in the terminated partnership) will become
 - his or her basis in any assets received in the liquidation, or
 - his or her basis in a new entity, if the terminated partnership is incorporated or turned into a new partnership (by merger, consolidation, division, or transfer of half or more of the interests in the terminated partnership), so that
 - gain or loss on the liquidation is deferred until the by-then ex-partners in the liquidated partnership sell (or exchange) whatever they received at the time it was liquidated.
- a. True
b. False
6. The reason that the statement in Question 5 was described as a "general" rule is that the particular way in which a partnership liquidation is done could affect the amount of tax that gets paid if the partners in a liquidated partnership have different bases in their partnership interests than the partnership itself has in its assets. In those cases, one form of liquidation may be less expensive, tax-wise, than others.
- a. True
b. False
7. If your answer to Question 6 was "b" (False), what other reasons – besides inconsistencies between inside and outside bases – might affect which form of liquidation is best, tax-wise?

Study Guide 26

ENDING A BUSINESS

Liquidating a Corporation

Taxing the Shareholders

Taxing the Corporation

Liquidating a Corporation

A corporation may liquidate by

- selling its assets and distributing *cash* (and liabilities) to its shareholders,
- or
- distributing its *assets* (and liabilities) to its shareholders, and ceasing to exist.

Either way, there will be tax consequences to both the shareholders and the corporation. But the consequences are not very complicated. Indeed, by now – at semester’s end – most of the consequences are likely to be exactly what you’d expect, even without any further reading.

Note: “Liquidating” a corporation does not bring its corporate life to an end, nor does liquidation end a California corporation’s liability for the \$800 annual minimum California tax (SG 1.8). To end a corporation’s life and terminate its liability for minimum state taxes, it is necessary to *dissolve* the corporation following procedures mandated by *state* law.

Taxing the Shareholders

Read (in Schwarz & Lathrope)

Pages 245-248

The general rule concerning the consequences to shareholders is that they realize gain or loss, just as though they had sold their stock to someone else, even though they really received cash or property (or both) from their own liquidating corporation. Here is the Code section that does this:

§ 331. Gain or loss to shareholders in corporate liquidations

- (a) Distributions in complete liquidation treated as exchanges. Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

Don’t forget that if the shareholders’ stock in the liquidating corporation is “small business stock,” and the shareholders

- realize a gain, they will have to pay tax on just half their gain if they owned the stock for more than 5 years (Study Guide 20.2),
- suffer a loss, they will be able to deduct up to \$50,000 of their loss (\$100,000, if married filing jointly) against ordinary income (not just against capital gains, or \$3,000 in ordinary income, as would be the case if their stock were not “small business stock”) (Study Guide 20.4).

Also, while you're not forgetting things, you may be wondering what happens if the corporation has earnings and profits when it liquidates, and whether that means that the amount distributed to shareholders in a liquidation is treated (and thus taxed) as a *dividend* to the extent of the corporation's earnings and dividends. You may be wondering this – indeed, should be wondering this – because in Study Guide 20, you learned that if a corporation does have earnings and profits when it redeems stock from a shareholder, the amount distributed to that shareholder *may* be taxed as a dividend.

Indeed, the answer to Question 12 in Study Guide 20 was that Anne would have \$75,000 in income taxed as dividends when the corporation redeemed 500 shares worth \$75,000, because the corporation then had \$75,000 in retained earnings at the time it did so – all as required by Code §§ 302(d), 301(c)(1) and § 316(a).

“But wait,” you say – because you just refreshed your recollection of the facts in that question, and thus were reminded that Anne owned 3,000 shares before the redemption, so she still owned 2,500 afterwards – “if *all* of Anne's stock had been redeemed, § 302(b)(3) would have treated all of what she received as payment in *exchange* for her stock, *not* as a dividend, so she would be taxed only her gain, not on the entire payment. “And,” you say, “if the corporation were being completely liquidated, all of her stock would be redeemed, so §302(b)(3) (SG 20.6) would again treat all of what she received as a payment in exchange for her stock, not as a dividend.”

If you said all that, you're right. But just to be certain that the IRS doesn't attempt to tax shareholders on what they receive from a liquidation as though they were dividends, Congress added the following sections to the Code:

§ 331. Gain or loss to shareholders in corporate liquidations

-
- (b) Nonapplication of section 301. Section 301 (relating to effects on shareholder of distributions of property) shall not apply to any distribution of property . . . in complete liquidation.

§ 301. Distributions of property

- (a) In general. Except as otherwise provided in this chapter, a distribution of property . . . made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

-
- (c) Amount taxable. In the case of a distribution to which subsection (a) applies -
- (1) Amount constituting dividend. That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

§ 316. Dividend defined

- (a) General rule. For purposes of this subtitle, the term “dividend” means any distribution of property made by a corporation to its shareholders -
- . . . out of its earnings and profits. . . .

Code §§ 302(b)(3) and 331(b) seem to be redundant – because both treat the complete redemption of a shareholder’s stock as a sale, not as a dividend, even if the corporation has retained earnings – *if* the liquidation involves just a single distribution to shareholders. Some liquidations, though, take quite a while, so some corporations make more than one distribution to each shareholder. In cases of that sort, distributions made before the final distribution *might* have been considered dividends (if the corporation had retained earnings). But the Code is clear that such distributions are treated as part of a single complete liquidation:

§ 346. Definition and special rule

- (a) Complete liquidation. For purposes of this subchapter, a distribution shall be treated as in complete liquidation of a corporation if the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan.

Apparently, sections 331(b) and 346(a) are meant to ensure that all distributions in a series are treated like proceeds from the sale or exchange of stock, and not like dividends.

If cash is the only thing distributed to shareholders, you now know everything you need to know: shareholders realize gain or loss by subtracting their basis in the redeemed stock from the amount of cash they receive from the liquidating corporation. If, though, they receive property as well as cash, it’s also necessary to know what the shareholders’ bases will be in the property they receive. Since their gain or loss will be based on the fair market value of the property they receive, it should comfort you to learn that their bases in that property will be fair market value too:

§ 334. Basis of property received in liquidations

- (a) General rule. If property is received in a distribution in complete liquidation, and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.

Questions re Taxing the Shareholders

1. Anne, Beth, Carl and Doug decided to completely liquidate their corporation. At the time they decided to do so, the corporation had retained earnings of \$100,000, and cash in that amount as well. It's going to take a few months to shut down the corporation's operations completely, but the shareholders wanted to get some cash out before then. So they adopted a plan of liquidation – nothing fancier than minutes of a board meeting among the four of them, reciting that they had decided to completely liquidate the corporation – and they had the corporation redeem 250 shares of each shareholder's stock (out of the 1,000 shares they owned originally) in exchange for a \$25,000 cash distribution to each of them (\$100/share). Anne's and Doug's bases in their stock is \$100,000 (\$100/share); Beth's basis is \$50,000 (\$50/share); and Carl's basis is \$25,000 (\$25/share). What were the tax consequences be to the shareholders of the \$25,000 cash distribution?
 - a. Each had dividend income of \$25,000, as required by Code §§ 301(c) and 316(a), because the corporation had \$100,000 in retained earnings when the distribution was made and they still owned 750 shares of stock after the redemption.
 - b. Each of them had a capital gain of \$25,000, as required by Code § 331(a), because that is the amount of their gain on the redemption of 250 shares of their stock.
 - c. The tax consequences to Anne, Beth, Carl and Doug were different, because they have different bases in their stock. The corporation's distribution of \$25,000 resulted in no gain to Anne and Doug (\$0/share gain x 250 shares), while the distribution to Beth resulted in her having a capital gain of \$12,500 (\$50/share gain x 250 shares), and Carl will have a capital gain of \$18,750 (\$75/share gain x 250 shares).
2. The corporation sold most of the rest of its assets, and used the proceeds to pay its debts. That left the corporation with just one last asset: a building with a fair market value of \$500,000 (purchased by the corporation while it was in business), in which the corporation's basis was \$100,000. As its final act, the corporation distributed the building to Anne, Beth, Carl and Doug (as tenants in common). Did they have taxable income as a result of this distribution?
 - a. Yes. Each of them had a capital gain of \$100,000 – 25% (because there are four of them) of the difference between the corporation's \$100,000 basis and the building's \$500,000 fair market value.
 - b. No, not yet. Each of them will take his or her 25% share of the building with the corporation's \$100,000 basis so, if they later sell it for \$500,000, each will have a \$100,000 capital gain at that time.
 - c. Yes. Each of them realized \$125,000, but the tax consequences were different, because they have different bases in their stock. Anne and Doug had \$50,000 in capital gains, because their bases in their remaining stock (i.e., the stock they still had after the earlier \$25,000 redemption) was \$75,000 each (and $\$125,000 - \$75,000 = \$50,000$). Beth had \$87,500 in capital gains, because her basis in her remaining stock was \$37,500 ($\$125,000 - \$37,500 = \$87,500$). And Carl had \$106,250 in capital gains, because his basis in his remaining stock was \$18,750 ($\$125,000 - \$18,750 = \$106,250$).

3. Did you notice that the total amount *realized* by Anne, Beth, Carl and Doug was \$150,000 (\$25,000 in cash plus a \$125,000 interest in the building), and that the total amount of the capital gain realized by each was:
- | | | |
|------|-----------|--------------------------------------|
| Anne | \$50,000 | (\$0 cash + \$50,000 building) |
| Beth | \$100,000 | (\$12,500 cash + \$87,500 building) |
| Carl | \$125,000 | (\$18,750 cash + \$106,250 building) |
| Doug | \$50,000 | (\$0 cash + \$50,000 building) |
- and that each of these gains was exactly equal to the difference between \$150,000 and the basis that each shareholder had in his or her 1,000 shares of stock?
- Yes.
 - Now that you mention it, I do.
 - No, I don't see it, even now.
4. If Anne, Beth, Carl and Doug sell the building that was distributed to them, for the \$500,000 it was said to be worth when it was distributed, how much gain, if any, will they realize and have to recognize?
- \$125,000 each (25% of the total amount received).
 - \$100,000 each (25% of the difference between the corporation's basis and the amount received).
 - \$0 each (25% of the difference between the building's basis in their hands and the amount received).

Taxing the Corporation

Read (in Schwarz & Lathrope)

Pages 248-252

If a corporation sells assets itself as part of its liquidation, it must recognize any gains or losses it realizes from those sales (just the way it would if it were staying in business). Sometimes, though, at the very end, the corporation still has assets or liabilities, and – because it is the very end – the corporation simply distributes those assets or liabilities to its shareholders. If the fair market value of the assets exceeds the corporation’s basis in the distributed assets, the corporation must recognize the difference as a gain. And if the fair market value of the assets is less than the corporation’s basis, the corporation *may* be permitted to recognize the loss. Here are the Code sections that do this:

§ 336. Gain or loss recognized on property distributed in complete liquidation

- (a) General rule. Except as otherwise provided in this section . . . , gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.
- (b) Treatment of liabilities. If any property distributed in the liquidation is subject to liability or the shareholder assumes a liability of the liquidating corporation in connection with the distribution, for purposes of subsection (a) . . . , the fair market value of such property shall be treated as not less than the amount of such liability.
- . . .
- (d) Limitations on recognition of loss
 - (1) No loss recognized in certain distributions to related persons
 - (A) In general. No loss shall be recognized to a liquidating corporation on the distribution of any property to a related person (within the meaning of section 267) if -
 - (i) such distribution is not pro rata, or
 - (ii) such property is disqualified property.
 - (B) Disqualified property. For purposes of subparagraph (A), the term “disqualified property” means any property which is acquired by the liquidating corporation in a transaction to which section 351 applied, or as a contribution to capital, during the 5-year period ending on the date of the distribution. . . .

§ 267. Losses . . . with respect to transactions between related taxpayers

- (a) In general
 - (1) Deduction for losses disallowed. No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). . . .
- (b) Relationships. The persons referred to in subsection (a) are:
 - . . .
 - (2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual. . . .

Notice that Code § 336 contains two limits on a corporation's ability to claim a loss on the distribution of its assets in liquidation.

The first is in paragraph (b) which prevents corporations from manufacturing losses by claiming that the fair market value of any of its assets is less than any liability to which the asset is subject. For example, if a corporation owns real estate subject to a mortgage with a balance of \$500,000, paragraph (b) prevents the corporation from asserting that the property's fair market value is only \$400,000 which, if permitted, would have given the corporation a \$100,000 loss. Notice, too, that paragraph (b) prevents the corporation from claiming that the fair market value of the property is only \$400,000, *even if it is!* Of course, if the value of the property really is less than the mortgage, the corporation may sell the property before liquidating, actually suffer the loss, and claim the loss on its own tax return. Or the corporation may distribute the property, along with the mortgage, to its shareholders who will take the property with a basis that's greater than its fair market value, so if the shareholders then sold the property for its fair market value, *they* would suffer the loss which *they* could claim on their individual returns.

The second limit on a corporation's ability to claim a loss on the distribution of its assets in liquidation is in paragraph (d) which prevents corporations from deducting losses in connection with the distribution of property to a shareholder who owns more than 50% of its stock, unless the property is distributed to all shareholders pro rata, and the property was not acquired by the corporation (in the last five years) in exchange for its stock (i.e., in a § 351 transaction of the kind covered in Study Guide 3).

Questions re Taxing the Corporation

5. In Question 2 (above), the corporation's last remaining asset was a building with a fair market value of \$500,000 (purchased by the corporation while it was in business), in which the corporation's basis was \$100,000. As its final act, the corporation distributed the building to Anne, Beth, Carl and Doug (as tenants in common). Did the corporation have taxable income as a result of this distribution?
 - a. No, because the building's fair market value was used to determine the amount realized by Anne, Beth, Carl and Doug, so they, in effect, paid taxes on the difference between the building's value and the corporation's basis.
 - b. Yes, it had to recognize a gain of \$400,000 (\$500,000 fmv - \$100,000 basis), because that's exactly what § 336(a) requires.
6. If your answer to Question 5 was "b," does that mean that there is a double tax on the distribution of property in liquidation (if the property's value exceeds the corporation's basis)?
 - a. No, because the corporation may claim a credit against its tax for the amount of tax that Anne, Beth, Carl and Doug paid.
 - b. Yes, but there's often a double tax with corporations: the first tax is paid by the corporation when it realizes a profit, including gains from the sale of property; and a second tax when those profits are distributed to shareholders.

7. Suppose that the property distributed in Question 5 was subject to a mortgage of \$600,000, so the property's net value was actually a *negative* \$100,000. Would the corporation be able to recognize a loss on the distribution?
- No, it would not be able to recognize a loss, because § 336(b) requires the corporation to treat the property's fair market value as though it were \$600,000 which is the amount of the mortgage.
 - Yes, it would be able to recognize a loss, because the property and the mortgage were distributed to shareholders not one of whom owned more than 50% of the stock, and because the property was not acquired from any of the shareholders in exchange for its stock, so § 336(d) does not prohibit the corporation from claiming the loss.
8. The property distributed in Question 5 was "purchased by the corporation while it was in business." In other words, that property was *not* the property originally contributed by Beth in exchange for her stock. Suppose, though, that the corporation still owned the property that Beth contributed, and the corporation distributed that property to Beth in a complete liquidation that occurred less than five years after the corporation was formed. You'll recall that when Beth contributed her property, it had a fair market value of \$100,000, and her basis in it (and the corporation's) was \$50,000. Suppose that the property was not subject to any liens, but its fair market value had declined to just \$35,000 at the time of the liquidation. Would the corporation be able to claim a \$15,000 loss on the distribution?
- No, because the corporation distributed property it acquired from Beth in exchange for issuing stock to her, so § 336(d)(1)(B) bars the corporation from claiming a loss.
 - Yes. Since the property is not subject to any liens, § 336(b) would not prohibit the corporation from using its \$35,000 fair market value, which is \$15,000 less than the corporation's basis \$50,000 basis.
 - Yes, because even though the corporation acquired the property from Beth in exchange for issuing stock to her, § 336(d)(1)(B) does *not* bar the corporation from claiming a loss, because the property was distributed to Beth who is *not* a "related person" within the meaning of §§ 336(d)(1)(A) and 267(b)(2).
 - Both "b" and "c".

Study Guide 27

RECAP OF SECTION 754 ELECTIONS

Underlying legal/accounting concept

The legal and accounting concept that is at the heart of 754 elections is that

- *partners* have an *outside* basis in their partnership interests, and
- *partnerships* have an *inside* basis in the assets owned by partnership (SG 2.3)

Usually, the outside and inside bases are the same. Here, for example, is the balance sheet for our hypothetical partnership, when it was first organized:

<u>PARTNERSHIP'S ASSETS</u>			<u>PARTNERS' CAPITAL</u>		
	<u>Inside Basis</u>	<u>Book Value</u>		<u>Outside Basis</u>	<u>Capital Account</u>
Cash	\$100,000	\$100,000	Anne	\$100,000	\$100,000
Real Estate	\$ 50,000	\$100,000	Beth	\$ 50,000	\$100,000
Equipment	\$ 25,000	\$100,000	Carl	\$ 25,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$275,000	\$400,000	Total	\$275,000	\$400,000

Circumstances that may result in different outside and inside bases

While usually the outside and inside bases are the same, under a couple of circumstances they may become different.

- **Distributions by partnership to partner**

If a partnership distributes cash or property to a partner *in excess of that partner's outside basis in the partnership*, that partner's outside basis in the partnership will be reduced to \$0, and the partners' (aggregate) outside basis will differ from the partnership's inside basis.

Example 1:

Partnership distributes \$50,000 cash to Carl, not in liquidation of his interest (SG 10.1)

<u>PARTNERSHIP'S ASSETS</u>			<u>PARTNERS' CAPITAL</u>		
	<u>Inside Basis</u>	<u>Book Value</u>		<u>Outside Basis</u>	<u>Capital Account</u>
Cash	\$ 50,000	\$ 50,000	Anne	\$100,000	\$100,000
Real Estate	\$ 50,000	\$100,000	Beth	\$ 50,000	\$100,000
Equipment	\$ 25,000	\$100,000	Carl	\$ 0	\$ 50,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$225,000	\$350,000	Total	\$250,000	\$350,000

Example 2:

Partnership distributes \$100,000 cash to Carl, in liquidation of his interest (§736(b)(1) at SG 18.2)

<u>PARTNERSHIP'S ASSETS</u>			<u>PARTNERS' CAPITAL</u>		
	<u>Inside Basis</u>	<u>Book Value</u>		<u>Outside Basis</u>	<u>Capital Account</u>
Cash	\$ 0	\$ 0	Anne	\$100,000	\$100,000
Real Estate	\$ 50,000	\$100,000	Beth	\$ 50,000	\$100,000
Equipment	\$ 25,000	\$100,000	Carl	\$ 0	\$ 0
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$175,000	\$300,000	Total	\$250,000	\$300,000

Example 3:

Partnership distributes the real estate to Carl, in liquidation of his interest (SG 10.4 – 10.5):

<u>PARTNERSHIP'S ASSETS</u>			<u>PARTNERS' CAPITAL</u>		
	<u>Inside Basis</u>	<u>Book Value</u>		<u>Outside Basis</u>	<u>Capital Account</u>
Cash	\$100,000	\$100,000	Anne	\$100,000	\$100,000
Real Estate	\$ 0	\$ 0	Beth	\$ 50,000	\$100,000
Equipment	\$ 25,000	\$100,000	Carl	\$ 0	\$ 0
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$225,000	\$300,000	Total	\$250,000	\$300,000

- **Transfer of partnership interest by partner to new partner**

If a partner's interest in the partnership is transferred to a new partner, the new partner gets his or her own outside basis in that interest, and the partners' (aggregate) outside basis may be different from the partnership's inside basis.

Example 1:

Beth sells her partnership interest to Frank for \$100,000 and he becomes a new partner. Frank's outside basis in the partnership interest is the \$100,000 he paid for it. (SG 17.6)

<u>PARTNERSHIP'S ASSETS</u>			<u>PARTNERS' CAPITAL</u>		
	<u>Inside Basis</u>	<u>Book Value</u>		<u>Outside Basis</u>	<u>Capital Account</u>
Cash	\$100,000	\$100,000	Anne	\$100,000	\$100,000
Real Estate	\$ 50,000	\$100,000	Frank	\$100,000	\$100,000
Equipment	\$ 25,000	\$100,000	Carl	\$ 25,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$275,000	\$400,000	Total	\$325,000	\$400,000

Example 2:

Beth dies, and her partnership interest passes to Frank, her successor. At the time of her death, the fair market value of her partnership interest is \$100,000. Frank's outside basis in the partnership interest is \$100,000 (i.e., its fair market value at the time of Beth's death). (§ 1014(a) and (b) at SG 19.5)

<u>PARTNERSHIP'S ASSETS</u>			<u>PARTNERS' CAPITAL</u>		
	<u>Inside Basis</u>	<u>Book Value</u>		<u>Outside Basis</u>	<u>Capital Account</u>
Cash	\$100,000	\$100,000	Anne	\$100,000	\$100,000
Real Estate	\$ 50,000	\$100,000	Frank	\$100,000	\$100,000
Equipment	\$ 25,000	\$100,000	Carl	\$ 25,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$275,000	\$400,000	Total	\$325,000	\$400,000

The circumstance that may trigger tax consequences resulting from different outside and inside bases

Nothing happens automatically when a partnership's inside basis in its assets becomes different from the partners' outside bases in their partnership interests.

However, if and when a *partnership sells any of its assets*, the difference between the partnership's inside basis and the partners' outside bases may result in the same gain being taxed twice, or the same loss being deducted twice.

“Section 754 Election”

A section 754 election permits a partnership to increase the inside basis of its assets, so that if there is a gain on the sale of those assets, the gain will not be taxed twice. Alas, once the election is made, the partnership is stuck with it, so that if later, the partnership distributes more cash or property, or another partnership interest is transferred, under circumstances that result in a loss, the partnership must decrease the inside basis of its assets so that the loss is not deducted twice.

The specific way in which a basis adjustment is done depends on whether it is done in connection with

- the partnership’s *distribution* of cash or property, in which case, the *partnership’s* inside basis in its remaining assets is adjusted as provided in § 734(b) (SG 11.2),
or
- the *transfer* of a partnership interest, in which case the partnership’s inside basis in the *new partner’s share* of the partnership’s assets is adjusted as provided in § 743(b) (SG 17.8 re sale to new partner; SG 18.5 re liquidation of living partner’s interest; SG 19.6 re liquidation of deceased partner’s interest; SG 25.16 re liquidating entire partnership).

Partnership distribution of cash or property

Here again is the balance sheet of our hypothetical partnership, before any distributions are made.

<u>PARTNERSHIP’S ASSETS</u>			<u>PARTNERS’ CAPITAL</u>		
	<u>Inside Basis</u>	<u>Book Value</u>		<u>Outside Basis</u>	<u>Capital Account</u>
Cash	\$100,000	\$100,000	Anne	\$100,000	\$100,000
Real Estate	\$ 50,000	\$100,000	Beth	\$ 50,000	\$100,000
Equipment	\$ 25,000	\$100,000	Carl	\$ 25,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$275,000	\$400,000	Total	\$275,000	\$400,000

If the partnership distributes \$100,000 cash to Carl (in liquidation of his interest), Carl will have \$75,000 in gain, on which he will have to pay tax. This gain is equal to the difference between his \$25,000 basis in the partnership (which carried over from the \$25,000 basis he had in the equipment that he contributed when the partnership was formed), and the \$100,000 that was distributed to him.

Note that the liquidation of Carl’s interest is *economically equivalent* to what would have happened if, at the outset, the partnership had *purchased* the equipment from Carl for \$100,000, without making him a partner. Note also that if the partnership had purchased the equipment from Carl at the outset (and not made him a partner), the partnership would have had a \$100,000 basis in the equipment, so if the partnership then sold the equipment for \$100,000, it would not realize a gain.

However, because Carl contributed the equipment to the partnership in return for his partnership interest, the partnership’s basis in the equipment is handled differently when his interest was liquidated by the partnership. How, exactly, it’s handled depends on whether the partnership makes a 754 election or doesn’t.

- **Tax consequence without 754 election**

If a 754 election is *not* made, no adjustment is made to the partnership's inside basis in its remaining assets, and the balance sheet will look like this after the partnership distributes \$100,000 to Carl:

<u>PARTNERSHIP'S ASSETS</u>			<u>PARTNERS' CAPITAL</u>		
	<u>Inside Basis</u>	<u>Book Value</u>		<u>Outside Basis</u>	<u>Capital Account</u>
Cash	\$ 0	\$ 0	Anne	\$100,000	\$100,000
Real Estate	\$ 50,000	\$100,000	Beth	\$ 50,000	\$100,000
Equipment	\$ 25,000	\$100,000	Carl	\$ 0	\$ 0
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$175,000	\$300,000	Total	\$250,000	\$300,000

If the partnership then sold the equipment for \$100,000, the partnership would realize a gain of \$75,000, which would be allocated among, and taxed to, Anne, Beth and Doug – \$25,000 each – even though Carl already paid tax on that same \$75,000 gain.

- **Tax consequence with 754 election**

On the other hand, if a 754 election *is* made, the partnership's inside basis in the equipment will be increased, and the balance sheet will look something* like this:

<u>PARTNERSHIP'S ASSETS</u>			<u>PARTNERS' CAPITAL</u>		
	<u>Inside Basis</u>	<u>Book Value</u>		<u>Outside Basis</u>	<u>Capital Account</u>
Cash	\$ 0	\$ 0	Anne	\$100,000	\$100,000
Real Estate	\$ 50,000	\$100,000	Beth	\$ 50,000	\$100,000
Equipment	\$100,000	\$100,000	Carl	\$ 0	\$ 0
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$250,000	\$300,000	Total	\$250,000	\$300,000

If the partnership then sold the equipment for \$100,000, the partnership would not realize a gain, so the sale of the equipment would not result in tax to Anne, Beth or Doug.

* *An important point about how the partnership's inside basis would be increased:* Technically, if a 754 election were made, the \$75,000 increase in partnership's inside basis would be spread over the equipment *and* the real estate – some to each – pursuant to a formula set forth in § 755 (SG 17.9, and briefly explained in Schwarz & Lathrope at page 564). The \$75,000 basis increase would not be allocated entirely to the equipment, as it was in the balance sheet above. If I had used the § 755 formula to properly allocate the increase in basis when I created the balance sheet above, it would have made this example more authentic and the arithmetic more complicated. I didn't do the arithmetic required by §755, because even without a proper allocation, the essential point made by this example remains accurate: a 754 election increases the partnership's basis in its assets by \$75,000, so if the partnership later sells those assets, the partnership's gain from the sale will be \$75,000 less (than if no election had been made), so Anne, Beth and Doug will have \$75,000 less (among them) on which to pay tax.

Transfer of partnership interest

If Beth sells her partnership interest to Frank for \$100,000, Frank becomes a new partner, and his outside basis in the partnership interest is the \$100,000 he paid for it. (SG 17.6)

- **Tax consequence without 754 election**

Here again is what the balance sheet looks like, if *no* 754 election is made, so no adjustment is made to the partnership's inside basis in its remaining assets:

<u>PARTNERSHIP'S ASSETS</u>			<u>PARTNERS' CAPITAL</u>		
	<u>Inside Basis</u>	<u>Book Value</u>		<u>Outside Basis</u>	<u>Capital Account</u>
Cash	\$100,000	\$100,000	Anne	\$100,000	\$100,000
Real Estate	\$ 50,000	\$100,000	Frank	\$100,000	\$100,000
Equipment	\$ 25,000	\$100,000	Carl	\$ 25,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$275,000	\$400,000	Total	\$325,000	\$400,000

Frank's willingness to pay \$100,000 for Beth's partnership interest is attributable to his belief that the book values of the partnership's assets accurately reflect their fair market values, including the real estate's \$100,000 value.

When Frank paid Beth \$100,000 for her interest, she realized a \$50,000 gain on which she paid taxes, because her outside basis in the partnership was \$50,000 (because that was her basis in the real estate that she contributed to the partnership when it was formed).

If the partnership then sells the real estate for \$100,000, the partnership will realize a \$50,000 gain, all of which (the entire \$50,000) will be allocated and taxable to *Frank* (Schwarz & Lathrope 550 ¶ d). (The entire gain is allocated to Frank in *this case*, but see below for an explanation of the circumstances where the gain would be allocated among all of the partners.) In this case, the gain is allocated to Frank even though he already paid Beth for the difference between the partnership's \$50,000 basis and the real estate's \$100,000 fair market value, and even though Beth already paid tax on that difference. The balance sheet will look like this after the sale:

<u>PARTNERSHIP'S ASSETS</u>			<u>PARTNERS' CAPITAL</u>		
	<u>Inside Basis</u>	<u>Book Value</u>		<u>Outside Basis</u>	<u>Capital Account</u>
Cash	\$200,000	\$200,000	Anne	\$100,000	\$100,000
Real Estate	\$ 0	\$ 0	Frank	\$150,000	\$150,000
Equipment	\$ 25,000	\$100,000	Carl	\$ 25,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>	Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$325,000	\$400,000	Total	\$375,000	\$450,000

- **Tax consequence with 754 election**

On the other hand, if a 754 election *is* made, the partnership's inside basis in the real estate will be increased, so that *Frank* gets a stepped-up basis for the real estate. In *this case*, the entire step-up is allocated to Frank. (Frank gets the entire step-up in this case for the same reason the entire gain was allocated to him in the "no 754 election" case above. See below for an explanation of the circumstances where the step-up would be allocated among all of the partners.) The purpose of the step-up is to give Frank, but *not* the other partners, an increase in *his* share of inside basis of the real estate, so that when it is sold at a gain, Frank will not realize any gain. Here again is the balance sheet *before* the adjustment is made.

PARTNERSHIP'S ASSETS

	<u>Inside Basis</u>	<u>Book Value</u>
Cash	\$100,000	\$100,000
Real Estate	\$ 50,000	\$100,000
Equipment	\$ 25,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$275,000	\$400,000

PARTNERS' CAPITAL

	<u>Outside Basis</u>	<u>Capital Account</u>
Anne	\$100,000	\$100,000
Frank	\$100,000	\$100,000
Carl	\$ 25,000	\$100,000
Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$325,000	\$400,000

As a result of the 754 election, the balance sheet will look something* like this:

PARTNERSHIP'S ASSETS

	<u>Inside Basis</u>	<u>Book Value</u>
Cash	\$100,000	\$100,000
Real Estate	\$ 50,000	\$100,000
<i>Increase for Frank, only</i>	<i>\$ 50,000</i>	
Equipment	\$ 25,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$325,000	\$400,000

PARTNERS' CAPITAL

	<u>Outside Basis</u>	<u>Capital Account</u>
Anne	\$100,000	\$100,000
Frank	\$100,000	\$100,000
Carl	\$ 25,000	\$100,000
Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$325,000	\$400,000

If the partnership then sells the real estate for \$100,000, the partnership will realize a \$50,000 gain. The \$50,000 partnership gain will be *allocated* to Frank. (See Schwarz & Lathrope 550 ¶ d) But Frank will *not realize* a gain, because the \$50,000 allocated to him will be offset by the \$50,000 increase in his share of the partnership's inside basis in the real estate. The balance sheet will look something* like this, after the sale of the real estate:

PARTNERSHIP'S ASSETS

	<u>Inside Basis</u>	<u>Book Value</u>
Cash	\$200,000	\$200,000
Real Estate	\$ 0	\$ 0
Equipment	\$ 25,000	\$100,000
Services to be rendered	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$325,000	\$400,000

PARTNERS' CAPITAL

	<u>Outside Basis</u>	<u>Capital Account</u>
Anne	\$100,000	\$100,000
Frank	\$150,000	\$150,000
Carl	\$ 25,000	\$100,000
Doug	<u>\$100,000</u>	<u>\$100,000</u>
Total	\$375,000	\$450,000

* *An important point about how the partnership's inside basis would be increased:*

Technically, if a 754 election were made, the \$50,000 increase in Frank's inside basis would be spread over the equipment *and* the real estate – some to each – pursuant to a formula set forth in § 755 (SG 17.9, and briefly explained in Schwarz & Lathrope at page 564). The \$50,000 basis increase would not be allocated entirely to the real estate, as it was in the balance sheet above. If I had used the § 755 formula to properly allocate the increase in basis when I created the balance sheet above, it would have made this example more authentic and the arithmetic more complicated. I didn't do the arithmetic required by §755, because even without a proper allocation, the essential point made by this example remains accurate: a 754 election increases Frank's basis in the partnership's assets by \$50,000, so if the partnership later sells those assets, Frank's gain from the sale will be \$50,000 less than if no election had been made.

- **Why entire gain was allocated to Frank if 754 election was not made, and why entire step-up in basis was allocated to Frank if 754 election was made**

The entire gain was allocated to Frank in the “no 754 election” hypothetical, because

- he purchased *Beth’s* interest in the partnership,
- Beth had a low basis in her partnership interest, because it carried over from her below-fair-market-value basis in the real estate she contributed when the partnership was formed, i.e., Beth had a “built-in gain” in the real estate she contributed,
- the partnership’s basis in the real estate carried over from Beth’s below-fair-market-value basis,
- the partnership’s entire gain from the sale of the real estate was attributable to the built-in gain,
- Code § 704(c) would have required the partnership to allocate that entire gain to Beth, if she were still a partner (SG 8.1-8.4, especially Questions 2 & 3, the answers to which are 2/c and 3/d), and, finally,
- Reg 1.704-3(a)(7) provides that “If a contributing partner [e.g., Beth] transfers a partnership interest, built-in gain . . . must be allocated to the transferee partner [e.g., Frank] as it would have been allocated to the transferor partner [e.g., Beth].”

The entire basis step-up was allocated to Frank in the “754 election,” because that’s the way a 754 election offsets the amount of the gain that was allocated to him.

- **Circumstances under which gain or step-up would be allocated among all partners**

Gain or step-up would be allocated among all partners, in proportion to their ownership interests, if the gain were attributable to the property increasing in value while it was owned by the partnership (rather than being a built-in gain, as was the case in the hypothetical we’ve been working with all semester). For example, suppose that

- Anne, Beth, Carl and Doug had each contributed \$75,000 in cash to the partnership (\$300,000 total).
- The partnership used that \$300,000 to buy real estate.
- The real estate increased in value to \$400,000.
- Beth then sold her 25% interest in the partnership to Frank for \$100,000.
- The partnership then sold the real estate for \$400,000.

If no 754 election were made, the partnership would realize a \$100,000 gain (\$400,000 sale price - \$300,000 basis), and in this case, 25% of that gain – \$25,000 – would be allocated to Frank. (Because there was no built-in gain in this case, § 704(c) would not apply, so the allocation to Frank would be handled in the normal fashion.)

If a 754 election were made, Frank’s share of the partnership’s inside basis in the real estate would be increased by \$25,000. This amount is 25% (which is his share of the partnership) of the gain that would have been realized by the partnership if it had sold the real estate as soon as Frank bought Beth’s interest. Coincidentally, in this case, that’s the amount the partnership did sell the real estate for. If the partnership had sold the real estate a few years after Frank became a partner, so it increased in value still further – from \$400,000 to, say, \$500,000 – Frank’s share of the partnership’s inside basis in the real estate still would have been increased by \$25,000 (and only \$25,000). It is *not* a coincidence that this \$25,000 basis increase is equal to the gain realized by Beth when she sold her interest, in which she had a \$75,000 basis, to Frank for \$100,000.

Entity Classification Election

Type or Print	Name of eligible entity making election	Employer identification number
	Number, street, and room or suite no. If a P.O. box, see instructions.	
	City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code.	

▶ Check if: Address change

1 Type of election (see instructions):

- a** Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
- b** Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

- Yes.** Go to line 2b.
- No.** Skip line 2b and go to line 3.

2b Was the eligible entity's prior election for initial classification by a newly formed entity effective on the date of formation?

- Yes.** Go to line 3.
- No.** Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?

- Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
- No.** You can elect to be classified as an association taxable as a corporation or disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:

- a** Name of owner ▶
- b** Identifying number of owner ▶

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

- a** Name of parent corporation ▶
- b** Employer identification number ▶

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

What's New

- Disregarded entities not disregarded for employment and excise taxes. Beginning in 2008, disregarded entities, including single-member limited liability companies (LLCs) that are disregarded as separate from their owner and qualified subchapter S subsidiaries, are required to file certain excise tax returns using the disregarded entity's name and EIN rather than its owner's name and EIN. This new filing requirement for disregarded entities also applies to employment tax returns, effective for wages paid on or after January 1, 2009. Disregarded entities not previously needing an EIN may now need to obtain an EIN for the payment and reporting of these taxes. See *Employer Identification Number under Specific Instructions*, on page 5 for details.
- The Bulgarian entity *Aktsionerno Druzhestvo* has been added to the list of Foreign Entities Classified as Corporations for Federal Tax Purposes. See page 6.

Purpose of Form

An eligible entity uses Form 8832 to elect how it will be classified for federal tax purposes, as a corporation, a partnership, or an entity disregarded as separate from its owner. An eligible entity is classified for federal tax purposes under the default rules described below unless it files Form 8832 or Form 2553, Election by a Small Business Corporation, to elect a classification or change its current classification. See *Who Must File* on page 4.

The IRS will use the information entered on this form to establish the entity's filing and reporting requirements for federal tax purposes.

TIP *A new eligible entity should not file Form 8832 if it will be using its default classification (see Default Rules below).*

Eligible entity. An eligible entity is a business entity that is not included in items 1, or 3 through 9, under the definition of **corporation** provided under *Definitions*. Eligible entities include limited liability companies (LLCs) and partnerships.

Generally, corporations are not eligible entities. However, the following types of corporations are treated as eligible entities:

1. An eligible entity that previously elected to be an association taxable as a corporation by filing Form 8832. An entity that elects to be classified as a corporation by filing Form 8832 can make another election to change its classification (see the *60-month limitation rule* discussed below in the instructions for lines 2a and 2b).
2. A foreign eligible entity that became an association taxable as a corporation under the foreign default rule described below.

Default Rules

Existing entity default rule. Certain domestic and foreign entities that were in existence before January 1, 1997, and have an established federal tax classification generally do not need to make an election to continue that classification. If an existing entity decides to change its classification, it may do so subject to the 60-month limitation rule. See the instructions for lines 2a and 2b. See Regulations sections 301.7701-3(b)(3) and 301.7701-3(h)(2) for more details.

Domestic default rule. Unless an election is made on Form 8832, a domestic eligible entity is:

1. A partnership if it has two or more members.
2. Disregarded as an entity separate from its owner if it has a single owner.

A change in the number of members of an eligible entity classified as an **association** (defined below) does not affect the entity's classification. However, an eligible entity classified as a partnership will become a disregarded entity when the entity's membership is reduced to one member and a disregarded entity will be classified as a partnership when the entity has more than one member.

Foreign default rule. Unless an election is made on Form 8832, a foreign eligible entity is:

1. A partnership if it has two or more members and at least one member does not have limited liability.
2. An association taxable as a corporation if all members have limited liability.
3. Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

Definitions

Association. For purposes of this form, an association is an eligible entity taxable as a corporation by election or, for foreign eligible entities, under the default rules (see Regulations section 301.7701-3).

Business entity. A business entity is any entity recognized for federal tax purposes that is not properly classified as a trust under Regulations section 301.7701-4 or otherwise subject to special treatment under the Code regarding the entity's classification. See Regulations section 301.7701-2(a).

Corporation. For federal tax purposes, a corporation is any of the following:

1. A business entity organized under a federal or state statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic.
2. An association (as determined under Regulations section 301.7701-3).
3. A business entity organized under a state statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association.

4. An insurance company.
5. A state-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute.

6. A business entity wholly owned by a state or any political subdivision thereof, or a business entity wholly owned by a foreign government or any other entity described in Regulations section 1.892-2T.

7. A business entity that is taxable as a corporation under a provision of the Code other than section 7701(a)(3).

8. A foreign business entity listed on page 6. See Regulations section 301.7701-2(b)(8) for any exceptions and inclusions to items on this list and for any revisions made to this list since these instructions were printed.

9. An entity created or organized under the laws of more than one jurisdiction (business entities with multiple charters) if the entity is treated as a corporation with respect to any one of the jurisdictions. See Regulations section 301.7701-2(b)(9) for examples.

Disregarded entity. A disregarded entity is an eligible entity that is treated as an entity not separate from its single owner for income tax purposes. A "disregarded entity" is treated as separate from its owner for:

- Employment tax purposes, effective for wages paid on or after January 1, 2009; and
- Excise taxes reported on Forms 720, 730, 2290, 11-C, or 8849, effective for excise taxes reported and paid after December 31, 2007.

See the employment tax and excise tax return instructions for more information.

Limited liability. A member of a foreign eligible entity has limited liability if the member has no personal liability for any debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law under which the entity is organized (and, if relevant, the entity's organizational documents). A member has personal liability if the creditors of the entity may seek satisfaction of all or any part of the debts or claims against the entity from the member as such. A member has personal liability even if the member makes an agreement under which another person (whether or not a member of the entity) assumes that liability or agrees to indemnify that member for that liability.

Partnership. A partnership is a business entity that has at least two members and is not a corporation as defined on page 3 under *Corporation*.

Who Must File

File this form for an eligible entity that is one of the following:

- A domestic entity electing to be classified as an association taxable as a corporation.
- A domestic entity electing to change its current classification (even if it is currently classified under the default rule).

- A foreign entity that has more than one owner, all owners having limited liability, electing to be classified as a partnership.
- A foreign entity that has at least one owner that does not have limited liability, electing to be classified as an association taxable as a corporation.
- A foreign entity with a single owner having limited liability, electing to be an entity disregarded as an entity separate from its owner.
- A foreign entity electing to change its current classification (even if it is currently classified under the default rule).

Do not file this form for an eligible entity that is:

- Tax-exempt under section 501(a);
- A real estate investment trust (REIT), as defined in section 856; or
- Electing to be classified as an S corporation. An eligible entity that timely files Form 2553 to elect classification as an S corporation and meets all other requirements to qualify as an S corporation is deemed to have made an election under Regulations section 301.7701-3(c)(v) to be classified as an association taxable as a corporation.

All three of these entities are deemed to have made an election to be classified as an association.

Effect of Election

The federal tax treatment of elective changes in classification as described in Regulations section 301.7701-3(g)(1) is summarized as follows:

- If an eligible entity classified as a partnership elects to be classified as an association, it is deemed that the partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.
- If an eligible entity classified as an association elects to be classified as a partnership, it is deemed that the association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.
- If an eligible entity classified as an association elects to be disregarded as an entity separate from its owner, it is deemed that the association distributes all of its assets and liabilities to its single owner in liquidation of the association.
- If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to have contributed all of the assets and liabilities of the entity to the association in exchange for the stock of the association.

Note. For information on the federal tax consequences of elective changes in classification, see Regulations section 301.7701-3(g).

When To File

An election specifying an eligible entity's classification cannot take effect more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date the election is filed.

Late election relief. An eligible entity may be eligible for late election relief under Rev. Proc. 2009-41, 2009-39 I.R.B. 439, if **each** of the following requirements is met.

1. The entity failed to obtain its requested classification as of the date of its formation (or upon the entity's classification becoming relevant) or failed to obtain its requested change in classification solely because Form 8832 was not filed timely.

2. Either:

a. The entity has not filed a federal tax or information return for the first year in which the election was intended because the due date has not passed for that year's federal tax or information return; or

b. The entity has timely filed all required federal tax returns and information returns (or if not timely, within 6 months after its due date, excluding extensions) consistent with its requested classification for all of the years the entity intended the requested election to be effective and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the tax years. If the eligible entity is not required to file a federal tax return or information return, each affected person who is required to file a federal tax return or information return must have timely filed all such returns consistent with the entity's requested classification for all of the years the entity intended the requested election to be effective and no inconsistent tax or information returns have been filed during any of the tax years.

3. The entity has reasonable cause for its failure to timely make the entity classification election.

4. Three years and 75 days from the requested effective date of the eligible entity's classification election have not passed.

An affected person (referred to in requirement 2b above) includes any direct or indirect owner of the electing entity that would have been required to attach a copy of the electing entity's Form 8832 to the owner's federal tax or information return (see the instructions under *Where To File* and Rev. Proc. 2009-41 for details).

To obtain relief, file Form 8832 with the applicable IRS service center listed in *Where To File*, earlier, within 3 years and 75 days from the requested effective date of the eligible entity's classification election. Include both a declaration that the elements required for relief have been satisfied and a statement explaining the reason for the failure to file a timely entity classification election (reasonable cause statement). The entity should write "Filed Pursuant to Rev. Proc. 2009-41" at the top of Form 8832 and attach both the declaration and the reasonable cause statement to its Form 8832 that is filed with

the applicable IRS service center. The declaration and reasonable cause statement must be accompanied by a dated declaration, signed by an authorized representative of the eligible entity and any affected person, which states: "Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." The individual or individuals who sign the declaration must have personal knowledge of the facts and circumstances related to the election. The additional copy of the Form 8832 that is required under *Where to File*, below, to be attached to either the eligible entity's or the affected person's return does not need the writing at the top of the Form 8832, the declaration, or the reasonable cause statement.

If Rev. Proc. 2009-41 does not apply, an entity may seek relief for a late entity election by requesting a private letter ruling and paying a user fee in accordance with Rev. Proc. 2009-1, 2009-1 I.R.B. 1 (or its successor).

Where To File

File Form 8832 with the Internal Revenue Service Center for your state listed below.

In addition, attach a copy of Form 8832 to the entity's federal tax or information return for the tax year of the election. If the entity is not required to file a return for that year, a copy of its Form 8832 must be attached to the federal tax returns of all direct or indirect owners of the entity for the tax year of the owner that includes the date on which the election took effect. An indirect owner of the electing entity does not have to attach a copy of the Form 8832 to its tax return if an entity in which it has an interest is already filing a copy of the Form 8832 with its return. Failure to attach a copy of Form 8832 will not invalidate an otherwise valid election, but penalties may be assessed against persons who are required to, but do not, attach Form 8832.

Each member of the entity is required to file the member's return consistent with the entity election. Penalties apply to returns filed inconsistent with the entity's election.

If the entity's principal business, office, or agency is located in:	Use the following Internal Revenue Service Center address:
Connecticut, Delaware, District of Columbia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia, Wisconsin	Cincinnati, OH 45999

If the entity's principal business, office, or agency is located in:

Use the following Internal Revenue Service Center address:

Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Hawaii, Idaho, Iowa, Kansas, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Washington, Wyoming

Ogden, UT 84201

A foreign country or U.S. possession

Ogden, UT
84201-0023

Note. Also attach a copy to the entity's federal income tax return for the tax year of the election.

Acceptance or Nonacceptance of Election

The service center will notify the eligible entity at the address listed on Form 8832 if its election is accepted or not accepted. The entity should generally receive a determination on its election within 60 days after it has filed Form 8832.

Care should be exercised to ensure that the IRS receives the election. If the entity is not notified of acceptance or nonacceptance of its election within 60 days of the date of filing, take follow-up action by calling 1-800-829-0115, or by sending a letter to the service center to inquire about its status. Send any such letter by certified or registered mail via the U.S. Postal Service, or equivalent type of delivery by a designated private delivery service (see Notice 2004-83, 2004-52 I.R.B. 1030 (or its successor)).

If the IRS questions whether Form 8832 was filed, an acceptable proof of filing is:

- A certified or registered mail receipt (timely postmarked) from the U.S. Postal Service, or its equivalent from a designated private delivery service;
- Form 8832 with an accepted stamp;
- Form 8832 with a stamped IRS received date; or
- An IRS letter stating that Form 8832 has been accepted.

Specific Instructions

Name. Enter the name of the eligible entity electing to be classified.

Employer identification number (EIN). Show the EIN of the eligible entity electing to be classified.

Caution. Do not put "Applied For" on this line.

Note. Any entity that has an EIN will retain that EIN even if its federal tax classification changes under Regulations section 301.7701-3.

If a disregarded entity's classification changes so that it becomes recognized as a partnership or association for federal tax purposes, and that entity had an EIN, then the entity must continue to use that EIN. If the entity did not already have its own EIN, then the entity must apply for an EIN and not use the identifying number of the single owner.

A foreign person that makes an election under Regulations section 301.7701-3(c) and (d) must also use its own taxpayer identifying number. See sections 6721 through 6724 for penalties that may apply for failure to supply taxpayer identifying numbers.

If the entity electing to be classified using Form 8832 does not have an EIN, it must apply for one on Form SS-4, Application for Employer Identification Number. The entity must have received an EIN by the time Form 8832 is filed in order for the form to be processed. An election will not be accepted if the eligible entity does not provide an EIN.

Caution. Do not apply for a new EIN for an existing entity that is changing its classification if the entity already has an EIN.

Address. Enter the address of the entity electing a classification. All correspondence regarding the acceptance or nonacceptance of the election will be sent to this address. Include the suite, room, or other unit number after the street address. If the Post Office does not deliver mail to the street address and the entity has a P.O. box, show the box number instead of the street address. If the electing entity receives its mail in care of a third party (such as an accountant or an attorney), enter on the street address line "C/O" followed by the third party's name and street address or P.O. box.

Address change. If the eligible entity has changed its address since filing Form SS-4 or the entity's most recently-filed return (including a change to an "in care of" address), check the box for an address change.

Note. If a change of address occurs after the later of the filing of Form SS-4 or the most recently-filed return, use Form 8822, Change of Address, to notify the IRS of the new address. A new address shown on Form 8832 will not update the entity's address of record with the IRS.

Line 1. Check box 1a if the entity is choosing a classification for the first time (i.e., the entity does not want to be classified under the applicable default classification). Do not file this form if the entity wants to be classified under the default rules.

Check box 1b if the entity is changing its current classification.

Lines 2a and 2b. 60-month limitation rule.

Once an eligible entity makes an election to *change* its classification, the entity generally cannot change its classification by election again during the 60 months after the effective date of the election. However, the IRS may (by private letter ruling) permit the entity to change its classification by election within the 60-month period if more than 50% of the ownership interests in the entity, as of the effective date of the election, are owned by persons that did not own any interests in the entity on the effective date or the filing date of the entity's prior election.

Note. The 60-month limitation does not apply if the previous election was made by a *newly formed* eligible entity and was effective on the date of formation.

Line 4. If an eligible entity has only one owner, provide the name of its owner on line 4a and the owner's identifying number (social security number, or individual taxpayer identification number, or EIN) on line 4b. If the electing eligible entity is owned by an entity that is a disregarded entity or by an entity that is a member of a series of tiered disregarded entities, identify the first entity (the entity closest to the electing eligible entity) that is not a disregarded entity. For example, if the electing eligible entity is owned by disregarded entity A, which is owned by another disregarded entity B, and disregarded entity B is owned by partnership C, provide the name and EIN of partnership C as the owner of the electing eligible entity. If the owner is a foreign person or entity and does not have a U.S. identifying number, enter "none" on line 4b.

Line 5. If the eligible entity is owned by one or more members of an affiliated group of corporations that file a consolidated return, provide the name and EIN of the parent corporation.

Line 6. Check the appropriate box if you are changing a current classification (no matter how achieved), or are electing out of a default classification. Do not file this form if you fall within a default classification that is the desired classification for the new entity.

Line 7. If the entity making the election is created or organized in a foreign jurisdiction, enter the name of the foreign country in which it is organized. This information must be provided even if the entity is also organized under domestic law.

Line 8. Generally, the election will take effect on the date you enter on line 8 of this form, or on the date filed if no date is entered on line 8. An election specifying an entity's classification for federal tax purposes can take effect no more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date on which the election is filed. If line 8 shows a date more than 75 days prior to the date on which the election is filed, the election will default to 75 days before the date it is filed. If line 8 shows an effective date more than 12 months from the filing date, the election will take effect 12 months after the date the election is filed.

Consent statement and signature(s). Form 8832 must be signed by:

1. Each member of the electing entity who is an owner at the time the election is filed; or
2. Any officer, manager, or member of the electing entity who is authorized (under local law or the organizational documents) to make the election. The elector represents to having such authorization under penalties of perjury.

If an election is to be effective for any period prior to the time it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, must sign.

If you need a continuation sheet or use a separate consent statement, attach it to Form 8832. The separate consent statement must contain the same information as shown on Form 8832.

Note. Do not sign the copy that is attached to your tax return.

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping 1 hr., 49 min.

Learning about the law or the form 2 hr., 25 min

Preparing and sending the form to the IRS 23 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W: CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6406, Washington, DC 20224. Do not send the form to this address. Instead, see *Where To File* on page 4.

Foreign Entities Classified as Corporations for Federal Tax Purposes:

American Samoa—Corporation
Argentina—Sociedad Anonima
Australia—Public Limited Company
Austria—Aktiengesellschaft
Barbados—Limited Company
Belgium—Societe Anonyme
Belize—Public Limited Company
Bolivia—Sociedad Anonima
Brazil—Sociedade Anonima
Bulgaria—Aktisionerno Druzhestvo
Canada—Corporation and Company
Chile—Sociedad Anonima
People's Republic of China—Gufen Youxian Gongsi
Republic of China (Taiwan)—Ku-fen Yu-hsien Kung-szu
Colombia—Sociedad Anonima
Costa Rica—Sociedad Anonima
Cyprus—Public Limited Company
Czech Republic—Akciova Spolecnost
Denmark—Aktieselskab
Ecuador—Sociedad Anonima or Compania Anonima
Egypt—Sharikat Al-Mossahamah
El Salvador—Sociedad Anonima
Estonia—Aktisiaselts
European Economic Area/European Union—Societas Europaea
Finland—Julkinen Osakeyhtio/Publikit Aktiebolag
France—Societe Anonyme
Germany—Aktiengesellschaft
Greece—Anonymos Etairia
Guam—Corporation
Guatemala—Sociedad Anonima
Guyana—Public Limited Company
Honduras—Sociedad Anonima
Hong Kong—Public Limited Company
Hungary—Reszvenytarsasag
Iceland—Hlutafelag
India—Public Limited Company
Indonesia—Perseroan Terbuka
Ireland—Public Limited Company
Israel—Public Limited Company
Italy—Societa per Azioni
Jamaica—Public Limited Company
Japan—Kabushiki Kaisha
Kazakstan—Ashyk Aktisionerlik Kogham
Republic of Korea—Chusik Hoesa

Latvia—Akciju Sabiedriba
Liberia—Corporation
Liechtenstein—Aktiengesellschaft
Lithuania—Akcine Bendroves
Luxembourg—Societe Anonyme
Malaysia—Berhad
Malta—Public Limited Company
Mexico—Sociedad Anonima
Morocco—Societe Anonyme
Netherlands—Naamloze Vennootschap
New Zealand—Limited Company
Nicaragua—Compania Anonima
Nigeria—Public Limited Company
Northern Mariana Islands—Corporation
Norway—Allment Aksjeselskap
Pakistan—Public Limited Company
Panama—Sociedad Anonima
Paraguay—Sociedad Anonima
Peru—Sociedad Anonima
Philippines—Stock Corporation
Poland—Spolka Akcyjna
Portugal—Sociedade Anonima
Puerto Rico—Corporation
Romania—Societe pe Actiuni
Russia—Otkrytoye Aktisionernoy Obschestvo
Saudi Arabia—Sharikat Al-Mossahamah
Singapore—Public Limited Company
Slovak Republic—Akciova Spolocnost
Slovenia—Delniska Druzba
South Africa—Public Limited Company
Spain—Sociedad Anonima
Surinam—Naamloze Vennootschap
Sweden—Publika Aktiebolag
Switzerland—Aktiengesellschaft
Thailand—Borisat Chamkad (Mahachon)
Trinidad and Tobago—Limited Company
Tunisia—Societe Anonyme
Turkey—Anonim Sirket
Ukraine—Aktisionerne Tovaristvo Vidkritogo Tipu
United Kingdom—Public Limited Company
United States Virgin Islands—Corporation
Uruguay—Sociedad Anonima
Venezuela—Sociedad Anonima or Compania Anonima



See Regulations section 301.7701-2(b)(8) for any exceptions and inclusions to items on this list and for any revisions made to this list since these instructions were printed.

U.S. Return of Partnership Income

For calendar year 2009, or tax year beginning _____, 2009, ending _____, 20_____

OMB No. 1545-0099

2009

▶ See separate instructions.

A Principal business activity	Use the IRS label. Other- wise, print or type.	Name of partnership	D Employer identification number
B Principal product or service		Number, street, and room or suite no. If a P.O. box, see the instructions.	E Date business started
C Business code number		City or town, state, and ZIP code	F Total assets (see the instructions) \$ _____

- G** Check applicable boxes: (1) Initial return (2) Final return (3) Name change (4) Address change (5) Amended return
(6) Technical termination - also check (1) or (2)
- H** Check accounting method: (1) Cash (2) Accrual (3) Other (specify) ▶ _____
- I** Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ _____
- J** Check if Schedules C and M-3 are attached

Caution. Include **only** trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.

Income	1a	Gross receipts or sales	1a		
	b	Less returns and allowances	1b		1c
	2	Cost of goods sold (Schedule A, line 8)			2
	3	Gross profit. Subtract line 2 from line 1c			3
	4	Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)			4
	5	Net farm profit (loss) (attach Schedule F (Form 1040))			5
	6	Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			6
	7	Other income (loss) (attach statement)			7
	8	Total income (loss). Combine lines 3 through 7			8
Deductions <small>(see the instructions for limitations)</small>	9	Salaries and wages (other than to partners) (less employment credits)			9
	10	Guaranteed payments to partners			10
	11	Repairs and maintenance			11
	12	Bad debts			12
	13	Rent			13
	14	Taxes and licenses			14
	15	Interest			15
	16a	Depreciation (if required, attach Form 4562)	16a		
	b	Less depreciation reported on Schedule A and elsewhere on return	16b		16c
	17	Depletion (Do not deduct oil and gas depletion.)			17
	18	Retirement plans, etc.			18
	19	Employee benefit programs			19
	20	Other deductions (attach statement)			20
	21	Total deductions. Add the amounts shown in the far right column for lines 9 through 20			21
22	Ordinary business income (loss). Subtract line 21 from line 8			22	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member manager) is based on all information of which preparer has any knowledge.

▶ _____ ▶ _____
Signature of general partner or limited liability company member manager Date

May the IRS discuss this return with the preparer shown below (see instructions)? <input type="checkbox"/> Yes <input type="checkbox"/> No
--

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed <input type="checkbox"/>	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶ _____	EIN ▶ _____		Phone no. _____

Schedule A Cost of Goods Sold (see the instructions)

1	Inventory at beginning of year	1		
2	Purchases less cost of items withdrawn for personal use	2		
3	Cost of labor	3		
4	Additional section 263A costs (<i>attach statement</i>)	4		
5	Other costs (<i>attach statement</i>)	5		
6	Total. Add lines 1 through 5	6		
7	Inventory at end of year	7		
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8		

9a Check all methods used for valuing closing inventory:

(i) Cost as described in Regulations section 1.471-3

(ii) Lower of cost or market as described in Regulations section 1.471-4

(iii) Other (specify method used and attach explanation) ▶ _____

b Check this box if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) . . . ▶

c Check this box if the LIFO inventory method was adopted this tax year for any goods (*if checked, attach Form 970*) . . ▶

d Do the rules of section 263A (for property produced or acquired for resale) apply to the partnership? **Yes** **No**

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? . . **Yes** **No**
If "Yes," attach explanation.

Schedule B Other Information

	Yes	No
1 What type of entity is filing this return? Check the applicable box:		
a <input type="checkbox"/> Domestic general partnership		
b <input type="checkbox"/> Domestic limited partnership		
c <input type="checkbox"/> Domestic limited liability company		
d <input type="checkbox"/> Domestic limited liability partnership		
e <input type="checkbox"/> Foreign partnership		
f <input type="checkbox"/> Other ▶ _____		
2 At any time during the tax year, was any partner in the partnership a disregarded entity, a partnership (including an entity treated as a partnership), a trust, an S corporation, an estate (other than an estate of a deceased partner), or a nominee or similar person?		
3 At the end of the tax year:		
a Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership? For rules of constructive ownership, see instructions. If "Yes," attach Schedule B-1, Information on Partners Owning 50% or More of the Partnership		
b Did any individual or estate own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership? For rules of constructive ownership, see instructions. If "Yes," attach Schedule B-1, Information on Partners Owning 50% or More of the Partnership		
4 At the end of the tax year, did the partnership:		
a Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below		

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock

b Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below		
--	--	--

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Maximum Percentage Owned in Profit, Loss, or Capital

		Yes	No
5	Did the partnership file Form 8893, Election of Partnership Level Tax Treatment, or an election statement under section 6231(a)(1)(B)(ii) for partnership-level tax treatment, that is in effect for this tax year? See Form 8893 for more details		
6	Does the partnership satisfy all four of the following conditions? a The partnership's total receipts for the tax year were less than \$250,000. b The partnership's total assets at the end of the tax year were less than \$1 million. c Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return. d The partnership is not filing and is not required to file Schedule M-3 If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2; Item F on page 1 of Form 1065; or Item L on Schedule K-1.		
7	Is this partnership a publicly traded partnership as defined in section 469(k)(2)?		
8	During the tax year, did the partnership have any debt that was cancelled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt?		
9	Has this partnership filed, or is it required to file, Form 8918, Material Advisor Disclosure Statement, to provide information on any reportable transaction?		
10	At any time during calendar year 2009, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? See the instructions for exceptions and filing requirements for Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts. If "Yes," enter the name of the foreign country. ► _____		
11	At any time during the tax year, did the partnership receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the partnership may have to file Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. See instructions		
12a	Is the partnership making, or had it previously made (and not revoked), a section 754 election? See instructions for details regarding a section 754 election.		
b	Did the partnership make for this tax year an optional basis adjustment under section 743(b) or 734(b)? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions		
c	Is the partnership required to adjust the basis of partnership assets under section 743(b) or 734(b) because of a substantial built-in loss (as defined under section 743(d)) or substantial basis reduction (as defined under section 734(d))? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions.		
13	Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than entities wholly-owned by the partnership throughout the tax year) ► <input type="checkbox"/>		
14	At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?		
15	If the partnership is required to file Form 8858, Information Return of U.S. Persons With Respect To Foreign Disregarded Entities, enter the number of Forms 8858 attached. See instructions ► _____		
16	Does the partnership have any foreign partners? If "Yes," enter the number of Forms 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax, filed for this partnership. ► _____		
17	Enter the number of Forms 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, attached to this return. ► _____		

Designation of Tax Matters Partner (see instructions)

Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP	Identifying number of TMP
If the TMP is an entity, name of TMP representative	Phone number of TMP
Address of designated TMP	

Schedule K		Partners' Distributive Share Items		Total amount	
Income (Loss)	1	Ordinary business income (loss) (page 1, line 22)		1	
	2	Net rental real estate income (loss) (<i>attach Form 8825</i>)		2	
	3a	Other gross rental income (loss)	3a		
	b	Expenses from other rental activities (<i>attach statement</i>)	3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a		3c	
	4	Guaranteed payments		4	
	5	Interest income		5	
	6	Dividends: a Ordinary dividends		6a	
		b Qualified dividends	6b		
	7	Royalties		7	
	8	Net short-term capital gain (loss) (<i>attach Schedule D (Form 1065)</i>)		8	
9a	Net long-term capital gain (loss) (<i>attach Schedule D (Form 1065)</i>)		9a		
	b Collectibles (28%) gain (loss)	9b			
	c Unrecaptured section 1250 gain (<i>attach statement</i>)	9c			
	10 Net section 1231 gain (loss) (<i>attach Form 4797</i>)		10		
	11 Other income (loss) (<i>see instructions</i>) Type ▶		11		
Deductions	12	Section 179 deduction (<i>attach Form 4562</i>)		12	
	13a	Contributions		13a	
	b	Investment interest expense		13b	
	c	Section 59(e)(2) expenditures: (1) Type ▶ (2) Amount ▶		13c(2)	
	d Other deductions (<i>see instructions</i>) Type ▶		13d		
Self-Employment	14a	Net earnings (loss) from self-employment		14a	
	b	Gross farming or fishing income		14b	
	c	Gross nonfarm income		14c	
Credits	15a	Low-income housing credit (section 42(j)(5))		15a	
	b	Low-income housing credit (other)		15b	
	c	Qualified rehabilitation expenditures (rental real estate) (<i>attach Form 3468</i>)		15c	
	d	Other rental real estate credits (<i>see instructions</i>) Type ▶		15d	
	e	Other rental credits (<i>see instructions</i>) Type ▶		15e	
	f	Other credits (<i>see instructions</i>) Type ▶		15f	
Foreign Transactions	16a	Name of country or U.S. possession ▶		16b	
	b	Gross income from all sources		16c	
	c	Gross income sourced at partner level			
		<i>Foreign gross income sourced at partnership level</i>			
	d	Passive category ▶	e General category ▶	f Other ▶	16f
		<i>Deductions allocated and apportioned at partner level</i>			
	g	Interest expense ▶	h Other ▶		16h
		<i>Deductions allocated and apportioned at partnership level to foreign source income</i>			
	i	Passive category ▶	j General category ▶	k Other ▶	16k
	l Total foreign taxes (check one): ▶ Paid <input type="checkbox"/> Accrued <input type="checkbox"/>			16l	
	m Reduction in taxes available for credit (<i>attach statement</i>)		16m		
	n Other foreign tax information (<i>attach statement</i>)				
Alternative Minimum Tax (AMT) Items	17a	Post-1986 depreciation adjustment		17a	
	b	Adjusted gain or loss		17b	
	c	Depletion (other than oil and gas)		17c	
	d	Oil, gas, and geothermal properties—gross income		17d	
	e	Oil, gas, and geothermal properties—deductions		17e	
	f	Other AMT items (<i>attach statement</i>)		17f	
Other Information	18a	Tax-exempt interest income		18a	
	b	Other tax-exempt income		18b	
	c	Nondeductible expenses		18c	
	19a	Distributions of cash and marketable securities		19a	
	b	Distributions of other property		19b	
	20a	Investment income		20a	
	b Investment expenses		20b		
	c Other items and amounts (<i>attach statement</i>)				

Analysis of Net Income (Loss)

1	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 16l					1	
2	Analysis by partner type:						
	(i) Corporate	(ii) Individual (active)	(iii) Individual (passive)	(iv) Partnership	(v) Exempt organization	(vi) Nominee/Other	
a	General partners						
b	Limited partners						

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
Assets					
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts				
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities				
6	Other current assets (<i>attach statement</i>)				
7	Mortgage and real estate loans				
8	Other investments (<i>attach statement</i>)				
9a	Buildings and other depreciable assets				
b	Less accumulated depreciation				
10a	Depletable assets				
b	Less accumulated depletion				
11	Land (net of any amortization)				
12a	Intangible assets (amortizable only)				
b	Less accumulated amortization				
13	Other assets (<i>attach statement</i>)				
14	Total assets				
Liabilities and Capital					
15	Accounts payable				
16	Mortgages, notes, bonds payable in less than 1 year				
17	Other current liabilities (<i>attach statement</i>)				
18	All nonrecourse loans				
19	Mortgages, notes, bonds payable in 1 year or more				
20	Other liabilities (<i>attach statement</i>)				
21	Partners' capital accounts				
22	Total liabilities and capital				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note. Schedule M-3 may be required instead of Schedule M-1 (see instructions).

1	Net income (loss) per books		6	Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize): _____		a	Tax-exempt interest \$ _____	
3	Guaranteed payments (other than health insurance)		7	Deductions included on Schedule K, lines 1 through 13d, and 16l, not charged against book income this year (itemize):	
4	Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 16l (itemize):		a	Depreciation \$ _____	
a	Depreciation \$ _____		8	Add lines 6 and 7	
b	Travel and entertainment \$ _____		9	Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5	
5	Add lines 1 through 4				

Schedule M-2 Analysis of Partners' Capital Accounts

1	Balance at beginning of year		6	Distributions: a Cash	
2	Capital contributed: a Cash		b Property		
	b Property		7	Other decreases (itemize): _____	
3	Net income (loss) per books		8	Add lines 6 and 7	
4	Other increases (itemize): _____		9	Balance at end of year. Subtract line 8 from line 5	
5	Add lines 1 through 4				

Schedule K-1 (Form 1065)

2009

Department of the Treasury Internal Revenue Service

For calendar year 2009, or tax year beginning _____, 2009 ending _____, 20_____

Partner's Share of Income, Deductions, Credits, etc.

See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
B Partnership's name, address, city, state, and ZIP code
C IRS Center where partnership filed return
D Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number
F Partner's name, address, city, state, and ZIP code
G General partner or LLC member-manager / Limited partner or other LLC member
H Domestic partner / Foreign partner
I What type of entity is this partner?
J Partner's share of profit, loss, and capital (see instructions):
K Partner's share of liabilities at year end:
L Partner's capital account analysis:
M Did the partner contribute property with a built-in gain or loss?

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

Table with 4 columns: Line number, Description, Column number, and Other information. Rows include Ordinary business income (loss), Net rental real estate income (loss), Other net rental income (loss), Guaranteed payments, Interest income, Ordinary dividends, Qualified dividends, Royalties, Net short-term capital gain (loss), Net long-term capital gain (loss), Collectibles (28%) gain (loss), Unrecaptured section 1250 gain, Net section 1231 gain (loss), Other income (loss), Section 179 deduction, Other deductions, Self-employment earnings (loss), Distributions, and Other information.

*See attached statement for additional information.
For IRS Use Only

This list identifies the codes used on Schedule K-1 for all partners and provides summarized reporting information for partners who file Form 1040. For detailed reporting and filing information, see the separate Partner's Instructions for Schedule K-1 and the instructions for your income tax return.

- 1. Ordinary business income (loss).** Determine whether the income (loss) is passive or nonpassive and enter on your return as follows.
 - Passive loss *Report on* See the Partner's Instructions
 - Passive income Schedule E, line 28, column (g)
 - Nonpassive loss Schedule E, line 28, column (h)
 - Nonpassive income Schedule E, line 28, column (j)
- 2. Net rental real estate income (loss)** See the Partner's Instructions
- 3. Other net rental income (loss)**
 - Net income Schedule E, line 28, column (g)
 - Net loss See the Partner's Instructions
- 4. Guaranteed payments** Schedule E, line 28, column (j)
- 5. Interest income** Form 1040, line 8a
- 6a. Ordinary dividends** Form 1040, line 9a
- 6b. Qualified dividends** Form 1040, line 9b
- 7. Royalties** Schedule E, line 4
- 8. Net short-term capital gain (loss)** Schedule D, line 5, column (f)
- 9a. Net long-term capital gain (loss)** Schedule D, line 12, column (f)
- 9b. Collectibles (28%) gain (loss)** 28% Rate Gain Worksheet, line 4 (Schedule D instructions)
- 9c. Unrecaptured section 1250 gain** See the Partner's Instructions
- 10. Net section 1231 gain (loss)** See the Partner's Instructions
- 11. Other income (loss)**
 - Code*
 - A** Other portfolio income (loss) See the Partner's Instructions
 - B** Involuntary conversions See the Partner's Instructions
 - C** Sec. 1256 contracts & straddles Form 6781, line 1
 - D** Mining exploration costs recapture See Pub. 535
 - E** Cancellation of debt Form 1040, line 21 or Form 982
 - F** Other income (loss) See the Partner's Instructions
- 12. Section 179 deduction** See the Partner's Instructions
- 13. Other deductions**
 - A** Cash contributions (50%)
 - B** Cash contributions (30%)
 - C** Noncash contributions (50%)
 - D** Noncash contributions (30%)
 - E** Capital gain property to a 50% organization (30%)
 - F** Capital gain property (20%)
 - G** Contributions (100%)
 - H** Investment interest expense Form 4952, line 1
 - I** Deductions—royalty income Schedule E, line 18
 - J** Section 59(e)(2) expenditures See the Partner's Instructions
 - K** Deductions—portfolio (2% floor) Schedule A, line 23
 - L** Deductions—portfolio (other) Schedule A, line 28
 - M** Amounts paid for medical insurance Schedule A, line 1 or Form 1040, line 29
 - N** Educational assistance benefits See the Partner's Instructions
 - O** Dependent care benefits Form 2441, line 14
 - P** Preproductive period expenses See the Partner's Instructions
 - Q** Commercial revitalization deduction from rental real estate activities See Form 8582 instructions
 - R** Pensions and IRAs See the Partner's Instructions
 - S** Reforestation expense deduction See the Partner's Instructions
 - T** Domestic production activities information See Form 8903 instructions
 - U** Qualified production activities income Form 8903, line 7
 - V** Employer's Form W-2 wages Form 8903, line 15
 - W** Other deductions See the Partner's Instructions

14. Self-employment earnings (loss)
Note. If you have a section 179 deduction or any partner-level deductions, see the Partner's Instructions before completing Schedule SE.

- A** Net earnings (loss) from self-employment Schedule SE, Section A or B
- B** Gross farming or fishing income See the Partner's Instructions
- C** Gross non-farm income See the Partner's Instructions
- 15. Credits**
 - A** Low-income housing credit (section 42(j)(5)) from pre-2008 buildings See the Partner's Instructions
 - B** Low-income housing credit (other) from pre-2008 buildings See the Partner's Instructions
 - C** Low-income housing credit (section 42(j)(5)) from post-2007 buildings Form 8586, line 11
 - D** Low-income housing credit (other) from post-2007 buildings Form 8586, line 11
 - E** Qualified rehabilitation expenditures (rental real estate)
 - F** Other rental real estate credits
 - G** Other rental credits
 - H** Undistributed capital gains credit Form 1040, line 70; check box a
 - I** Alcohol and cellulosic biofuel fuels credit Form 6478, line 7
 - J** Work opportunity credit Form 5884, line 3

- | <i>Code</i> | <i>Report on</i> |
|---|---|
| K Disabled access credit | See the Partner's Instructions |
| L Empowerment zone and renewal community employment credit | Form 8844, line 3 |
| M Credit for increasing research activities | See the Partner's Instructions |
| N Credit for employer social security and Medicare taxes | Form 8846, line 5 |
| O Backup withholding | Form 1040, line 61 |
| P Other credits | See the Partner's Instructions |
| 16. Foreign transactions | |
| A Name of country or U.S. possession | } Form 1116, Part I |
| B Gross income from all sources | |
| C Gross income sourced at partner level | |
| <i>Foreign gross income sourced at partnership level</i> | |
| D Passive category | } Form 1116, Part I |
| E General category | |
| F Other | |
| <i>Deductions allocated and apportioned at partner level</i> | |
| G Interest expense | Form 1116, Part I |
| H Other | Form 1116, Part I |
| <i>Deductions allocated and apportioned at partnership level to foreign source income</i> | |
| I Passive category | } Form 1116, Part I |
| J General category | |
| K Other | |
| <i>Other information</i> | |
| L Total foreign taxes paid | Form 1116, Part II |
| M Total foreign taxes accrued | Form 1116, Part II |
| N Reduction in taxes available for credit | Form 1116, line 12 |
| O Foreign trading gross receipts | Form 8873 |
| P Extraterritorial income exclusion | Form 8873 |
| Q Other foreign transactions | See the Partner's Instructions |
| 17. Alternative minimum tax (AMT) items | |
| A Post-1986 depreciation adjustment | } See the Partner's Instructions and the Instructions for Form 6251 |
| B Adjusted gain or loss | |
| C Depletion (other than oil & gas) | |
| D Oil, gas, & geothermal—gross income | |
| E Oil, gas, & geothermal—deductions | |
| F Other AMT items | |
| 18. Tax-exempt income and nondeductible expenses | |
| A Tax-exempt interest income | Form 1040, line 8b |
| B Other tax-exempt income | See the Partner's Instructions |
| C Nondeductible expenses | See the Partner's Instructions |
| 19. Distributions | |
| A Cash and marketable securities | } See the Partner's Instructions |
| B Distribution subject to section 737 | |
| C Other property | |
| 20. Other information | |
| A Investment income | Form 4952, line 4a |
| B Investment expenses | Form 4952, line 5 |
| C Fuel tax credit information | Form 4136 |
| D Qualified rehabilitation expenditures (other than rental real estate) | See the Partner's Instructions |
| E Basis of energy property | See the Partner's Instructions |
| F Recapture of low-income housing credit (section 42(j)(5)) | Form 8611, line 8 |
| G Recapture of low-income housing credit (other) | Form 8611, line 8 |
| H Recapture of investment credit | See Form 4255 |
| I Recapture of other credits | See the Partner's Instructions |
| J Look-back interest—completed long-term contracts | See Form 8697 |
| K Look-back interest—income forecast method | See Form 8866 |
| L Dispositions of property with section 179 deductions | } See the Partner's Instructions |
| M Recapture of section 179 deduction | |
| N Interest expense for corporate partners | |
| O Section 453(l)(3) information | |
| P Section 453A(c) information | |
| Q Section 1260(b) information | |
| R Interest allocable to production expenditures | |
| S CCF nonqualified withdrawals | |
| T Depletion information—oil and gas | |
| U Amortization of reforestation costs | |
| V Unrelated business taxable income | |
| W Precontribution gain (loss) | |
| X Section 108(i) information | |
| Y Other information | |

Label

(See instructions on page 14.)

Use the IRS label.

Otherwise, please print or type.

Form header section containing personal information fields: Name, Social Security Number, Address, and Filing Status options.

Presidential Election Campaign

Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 14) [] You [] Spouse

Filing Status

- 1 [] Single
2 [] Married filing jointly (even if only one had income)
3 [] Married filing separately. Enter spouse's SSN above and full name here.
4 [] Head of household (with qualifying person).
5 [] Qualifying widow(er) with dependent child (see page 16)

Exemptions

Exemptions section including boxes 6a (Yourself), 6b (Spouse), 6c (Dependents table), and 6d (Total number of exemptions claimed).

Income

Table for Income section with rows 7 through 22, including wages, interest, dividends, and other income sources.

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 22.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

Adjusted Gross Income

Table for Adjusted Gross Income section with rows 23 through 37, detailing various deductions and adjustments.

Tax and Credits

38 Amount from line 37 (adjusted gross income)
39a Check [] You were born before January 2, 1945, [] Blind. Total boxes checked
b If your spouse itemizes on a separate return or you were a dual-status alien, see page 35 and check here
40a Itemized deductions (from Schedule A) or your standard deduction (see left margin)
b If you are increasing your standard deduction by certain real estate taxes, new motor vehicle taxes, or a net disaster loss, attach Schedule L and check here
41 Subtract line 40a from line 38
42 Exemptions. If line 38 is \$125,100 or less and you did not provide housing to a Midwestern displaced individual, multiply \$3,650 by the number on line 6d. Otherwise, see page 37
43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-
44 Tax (see page 37). Check if any tax is from: a [] Form(s) 8814 b [] Form 4972
45 Alternative minimum tax (see page 40). Attach Form 6251
46 Add lines 44 and 45
47 Foreign tax credit. Attach Form 1116 if required
48 Credit for child and dependent care expenses. Attach Form 2441
49 Education credits from Form 8863, line 29
50 Retirement savings contributions credit. Attach Form 8880
51 Child tax credit (see page 42)
52 Credits from Form: a [] 8396 b [] 8839 c [] 5695
53 Other credits from Form: a [] 3800 b [] 8801 c []
54 Add lines 47 through 53. These are your total credits
55 Subtract line 54 from line 46. If line 54 is more than line 46, enter -0-

Other Taxes

56 Self-employment tax. Attach Schedule SE
57 Unreported social security and Medicare tax from Form: a [] 4137 b [] 8919
58 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required
59 Additional taxes: a [] AEIC payments b [] Household employment taxes. Attach Schedule H
60 Add lines 55 through 59. This is your total tax

Payments

61 Federal income tax withheld from Forms W-2 and 1099
62 2009 estimated tax payments and amount applied from 2008 return
63 Making work pay and government retiree credits. Attach Schedule M
64a Earned income credit (EIC)
b Nontaxable combat pay election
65 Additional child tax credit. Attach Form 8812
66 Refundable education credit from Form 8863, line 16
67 First-time homebuyer credit. Attach Form 5405
68 Amount paid with request for extension to file (see page 72)
69 Excess social security and tier 1 RRTA tax withheld (see page 72)
70 Credits from Form: a [] 2439 b [] 4136 c [] 8801 d [] 8885
71 Add lines 61, 62, 63, 64a, and 65 through 70. These are your total payments

Refund

72 If line 71 is more than line 60, subtract line 60 from line 71. This is the amount you overpaid
73a Amount of line 72 you want refunded to you. If Form 8888 is attached, check here
b Routing number
c Type: [] Checking [] Savings
d Account number
74 Amount of line 72 you want applied to your 2010 estimated tax

Amount You Owe

75 Amount you owe. Subtract line 71 from line 60. For details on how to pay, see page 74
76 Estimated tax penalty (see page 74)

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 75)? [] Yes. Complete the following. [] No
Designee's name Phone no. Personal identification number (PIN)

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 15. Keep a copy for your records.
Your signature Date Your occupation Daytime phone number
Spouse's signature. If a joint return, both must sign. Date Spouse's occupation

Paid Preparer's Use Only

Preparer's signature Date Check if self-employed [] Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code EIN Phone no.

Standard Deduction for—
• People who check any box on line 39a, 39b, or 40b or who can be claimed as a dependent, see page 35.
• All others:
Single or Married filing separately, \$5,700
Married filing jointly or Qualifying widow(er), \$11,400
Head of household, \$8,350

If you have a qualifying child, attach Schedule EIC.

**SCHEDULE E
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss
(From rental real estate, royalties, partnerships,
S corporations, estates, trusts, REMICs, etc.)

OMB No. 1545-0074

2009

Attachment
Sequence No. **13**

▶ **Attach to Form 1040, 1040NR, or Form 1041.** ▶ **See Instructions for Schedule E (Form 1040).**

Name(s) shown on return

Your social security number

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C or C-EZ** (see page E-3). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

1	List the type and address of each rental real estate property :	2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: • 14 days or • 10% of the total days rented at fair rental value? (See page E-3)	Yes	No
			A	
			B	
			C	

Income:	Properties			Totals (Add columns A, B, and C.)
	A	B	C	
3 Rents received	3			3
4 Royalties received	4			4
Expenses:				
5 Advertising	5			
6 Auto and travel (see page E-4)	6			
7 Cleaning and maintenance	7			
8 Commissions.	8			
9 Insurance	9			
10 Legal and other professional fees	10			
11 Management fees	11			
12 Mortgage interest paid to banks, etc. (see page E-5)	12			12
13 Other interest.	13			
14 Repairs.	14			
15 Supplies	15			
16 Taxes	16			
17 Utilities	17			
18 Other (list) ▶	18			
19 Add lines 5 through 18.	19			19
20 Depreciation expense or depletion (see page E-5)	20			20
21 Total expenses. Add lines 19 and 20	21			
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-5 to find out if you must file Form 6198	22			
23 Deductible rental real estate loss. Caution. Your rental real estate loss on line 22 may be limited. See page E-5 to find out if you must file Form 8582 . Real estate professionals must complete line 43 on page 2	23	()	(
24 Income. Add positive amounts shown on line 22. Do not include any losses	24			24
25 Losses. Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25	()	
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2	26			26

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Your social security number

Caution. The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations Note. If you report a loss from an at-risk activity for which any amount is not at risk, you must check the box in column (e) on line 28 and attach Form 6198. See page E-1.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see page E-7 before completing this section. Yes No

Table with 5 columns: (a) Name, (b) Enter P for partnership; S for S corporation, (c) Check if foreign partnership, (d) Employer identification number, (e) Check if any amount is not at risk. Rows A, B, C, D.

Table with 5 columns: (f) Passive loss allowed, (g) Passive income from Schedule K-1, (h) Nonpassive loss from Schedule K-1, (i) Section 179 expense deduction from Form 4562, (j) Nonpassive income from Schedule K-1. Rows A, B, C, D, 29a Totals, 29b Totals, 30, 31, 32.

Part III Income or Loss From Estates and Trusts

Table with 2 columns: (a) Name, (b) Employer identification number. Rows A, B.

Table with 4 columns: (c) Passive deduction or loss allowed, (d) Passive income from Schedule K-1, (e) Deduction or loss from Schedule K-1, (f) Other income from Schedule K-1. Rows A, B, 34a Totals, 34b Totals, 35, 36, 37.

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs) - Residual Holder

Table with 5 columns: (a) Name, (b) Employer identification number, (c) Excess inclusion from Schedules Q, line 2c, (d) Taxable income (net loss) from Schedules Q, line 1b, (e) Income from Schedules Q, line 3b. Rows 38, 39.

Part V Summary

Table with 2 columns: Description, Amount. Rows 40, 41, 42, 43.

1120

U.S. Corporation Income Tax Return

OMB No. 1545-0123

Form Department of the Treasury Internal Revenue Service

For calendar year 2009 or tax year beginning , 2009, ending , 20

2009

See separate instructions.

A Check if:

- 1a Consolidated return (attach Form 851)
b Life/nonlife consolidated return
2 Personal holding co. (attach Sch. PH)
3 Personal service corp. (see instructions)
4 Schedule M-3 attached

Use IRS label. Otherwise, print or type.

Name
Number, street, and room or suite no. If a P.O. box, see instructions.
City or town, state, and ZIP code

B Employer identification number

C Date incorporated

D Total assets (see instructions)

\$

E Check if: (1) Initial return (2) Final return (3) Name change (4) Address change

Income section table with rows 1a-11 and columns for descriptions and amounts.

Deductions section table with rows 12-29 and columns for descriptions and amounts.

Tax, Refundable Credits, and Payments section table with rows 30-36 and columns for descriptions and amounts.

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature Here section with fields for Signature of officer, Date, Title, and a box for 'May the IRS discuss this return with the preparer shown below?'.

Paid Preparer's Use Only section with fields for Preparer's signature, Date, Check if self-employed, Preparer's SSN or PTIN, Firm's name, EIN, and Phone no.

Schedule A Cost of Goods Sold (see instructions)

1	Inventory at beginning of year	1		
2	Purchases	2		
3	Cost of labor	3		
4	Additional section 263A costs (attach schedule)	4		
5	Other costs (attach schedule)	5		
6	Total. Add lines 1 through 5	6		
7	Inventory at end of year	7		
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8		

9a Check all methods used for valuing closing inventory:

(i) Cost

(ii) Lower of cost or market

(iii) Other (Specify method used and attach explanation.) ▶ _____

b Check if there was a writedown of subnormal goods ▶

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO **9d** _____

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? Yes No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation Yes No

Schedule C Dividends and Special Deductions (see instructions)

	(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1 Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)		70	
2 Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3 Dividends on debt-financed stock of domestic and foreign corporations		see instructions	
4 Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5 Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6 Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	
7 Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8 Dividends from wholly owned foreign subsidiaries		100	
9 Total. Add lines 1 through 8. See instructions for limitation			
10 Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11 Dividends from affiliated group members		100	
12 Dividends from certain FSCs		100	
13 Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14 Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15 Foreign dividend gross-up			
16 IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17 Other dividends			
18 Deduction for dividends paid on certain preferred stock of public utilities			
19 Total dividends. Add lines 1 through 17. Enter here and on page 1, line 4 ▶			
20 Total special deductions. Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			

Schedule E Compensation of Officers (see instructions for page 1, line 12)

Note: Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1) are \$500,000 or more.

	(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned		(f) Amount of compensation
				(d) Common	(e) Preferred	
1			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
2	Total compensation of officers					
3	Compensation of officers claimed on Schedule A and elsewhere on return					
4	Subtract line 3 from line 2. Enter the result here and on page 1, line 12					

Schedule J Tax Computation (see instructions)

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120))	<input type="checkbox"/>		
2	Income tax. Check if a qualified personal service corporation (see instructions)	<input type="checkbox"/>	2	
3	Alternative minimum tax (attach Form 4626)		3	
4	Add lines 2 and 3		4	
5a	Foreign tax credit (attach Form 1118)		5a	
b	Credit from Form 8834, line 29		5b	
c	General business credit (attach Form 3800)		5c	
d	Credit for prior year minimum tax (attach Form 8827)		5d	
e	Bond credits from Form 8912		5e	
6	Total credits. Add lines 5a through 5e		6	
7	Subtract line 6 from line 4		7	
8	Personal holding company tax (attach Schedule PH (Form 1120))		8	
9	Other taxes. Check if from: <input type="checkbox"/> Form 4255 <input type="checkbox"/> Form 8611 <input type="checkbox"/> Form 8697 <input type="checkbox"/> Form 8866 <input type="checkbox"/> Form 8902 <input type="checkbox"/> Other (attach schedule)		9	
10	Total tax. Add lines 7 through 9. Enter here and on page 1, line 31		10	

Schedule K Other Information (see instructions)

1	Check accounting method: a <input type="checkbox"/> Cash b <input type="checkbox"/> Accrual c <input type="checkbox"/> Other (specify) ▶ _____	Yes	No
2	See the instructions and enter the: a Business activity code no. ▶ _____ b Business activity ▶ _____ c Product or service ▶ _____		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidary controlled group? If "Yes," enter name and EIN of the parent corporation ▶ _____		
4	At the end of the tax year: a Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G) b Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes", complete Part II of Schedule G (Form 1120) (attach Schedule G)		
5	At the end of the tax year, did the corporation: a Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on Form 851 , Affiliations Schedule? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv).	Yes	No

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock

Schedule K *Continued*

b Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv).

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Country of Organization	(iv) Maximum Percentage Owned in Profit, Loss, or Capital

6 During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.)
If "Yes," file **Form 5452**, Corporate Report of Nondividend Distributions.

If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.

7 At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of **(a)** the total voting power of all classes of the corporation's stock entitled to vote or **(b)** the total value of all classes of the corporation's stock?

For rules of attribution, see section 318. If "Yes," enter:

(i) Percentage owned ▶ _____ and **(ii)** Owner's country ▶ _____

(c) The corporation may have to file **Form 5472**, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ▶ _____

8 Check this box if the corporation issued publicly offered debt instruments with original issue discount
If checked, the corporation may have to file **Form 8281**, Information Return for Publicly Offered Original Issue Discount Instruments.

9 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ \$ _____

10 Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶ _____

11 If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here

If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.

12 Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ▶ \$ _____

13 Are the corporation's total receipts (line 1a plus lines 4 through 10 on page 1) for the tax year **and** its total assets at the end of the tax year less than \$250,000?

If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ▶ \$ _____

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
Assets					
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts	()		()	
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach schedule)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach schedule)				
10a	Buildings and other depreciable assets				
b	Less accumulated depreciation	()		()	
11a	Depletable assets				
b	Less accumulated depletion	()		()	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	()		()	
14	Other assets (attach schedule)				
15	Total assets				
Liabilities and Shareholders' Equity					
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach schedule)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach schedule)				
22	Capital stock: a Preferred stock				
	b Common stock				
23	Additional paid-in capital				
24	Retained earnings—Appropriated (attach schedule)				
25	Retained earnings—Unappropriated				
26	Adjustments to shareholders' equity (attach schedule)				
27	Less cost of treasury stock	()		()	
28	Total liabilities and shareholders' equity				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return
Note: Schedule M-3 required instead of Schedule M-1 if total assets are \$10 million or more—see instructions

1	Net income (loss) per books		7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books			Tax-exempt interest \$ _____	
3	Excess of capital losses over capital gains			_____	
4	Income subject to tax not recorded on books this year (itemize): _____			_____	
5	Expenses recorded on books this year not deducted on this return (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
a	Depreciation \$ _____		a	Depreciation \$ _____	
b	Charitable contributions \$ _____		b	Charitable contributions \$ _____	
c	Travel and entertainment \$ _____			_____	
6	Add lines 1 through 5		9	Add lines 7 and 8	
			10	Income (page 1, line 28)—line 6 less line 9	

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1	Balance at beginning of year		5	Distributions: a Cash	
2	Net income (loss) per books			b Stock	
3	Other increases (itemize): _____			c Property	
	_____		6	Other decreases (itemize): _____	
	_____		7	Add lines 5 and 6	
4	Add lines 1, 2, and 3		8	Balance at end of year (line 4 less line 7)	

Election by a Small Business Corporation
 (Under section 1362 of the Internal Revenue Code)

OMB No. 1545-0146

▶ See Parts II and III on page 3 and the separate instructions.
 ▶ The corporation can fax this form to the IRS (see separate instructions).

Note. This election to be an S corporation can be accepted only if all the tests are met under **Who May Elect** on page 1 of the instructions; all shareholders have signed the consent statement; an officer has signed below; and the exact name and address of the corporation and other required form information are provided.

Part I Election Information Type or Print	Name (see instructions)	A Employer identification number : :
	Number, street, and room or suite no. (If a P.O. box, see instructions.)	B Date incorporated
	City or town, state, and ZIP code	C State of incorporation

D Check the applicable box(es) if the corporation, after applying for the EIN shown in **A** above, changed its name or address

E Election is to be effective for tax year beginning (month, day, year) (see instructions) ▶ / /

Caution. A corporation (entity) making the election for its first tax year in existence will usually enter the beginning date of a short tax year that begins on a date other than January 1.

F Selected tax year:

- (1) Calendar year
- (2) Fiscal year ending (month and day) ▶ _____
- (3) 52-53-week year ending with reference to the month of December
- (4) 52-53-week year ending with reference to the month of ▶ _____

If box (2) or (4) is checked, complete Part II

G If more than 100 shareholders are listed for item J (see page 2), check this box if treating members of a family as one shareholder results in no more than 100 shareholders (see test 2 under **Who May Elect** in the instructions) ▶

H Name and title of officer or legal representative who the IRS may call for more information	I Telephone number of officer or legal representative ()
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If this S corporation election is being filed with Form 1120S, I declare that I had reasonable cause for not filing Form 2553 timely, and if this election is made by an entity eligible to elect to be treated as a corporation, I declare that I also had reasonable cause for not filing an entity classification election timely. See below for my explanation of the reasons the election or elections were not made on time (see instructions).

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Sign Here	Under penalties of perjury, I declare that I have examined this election, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.		
	Signature of officer	Title	Date

Part I Election Information (continued)

J Name and address of each shareholder or former shareholder required to consent to the election. (See the instructions for column K.)	K Shareholders' Consent Statement. Under penalties of perjury, we declare that we consent to the election of the above-named corporation to be an S corporation under section 1362(a) and that we have examined this consent statement, including accompanying schedules and statements, and to the best of our knowledge and belief, it is true, correct, and complete. We understand our consent is binding and may not be withdrawn after the corporation has made a valid election. (Sign and date below.)		L Stock owned or percentage of ownership (see instructions)		M Social security number or employer identification number (see instructions)	N Shareholder's tax year ends (month and day)
			Number of shares or percentage of ownership	Date(s) acquired		
	Signature	Date				

Part II Selection of Fiscal Tax Year (see instructions)

Note. All corporations using this part must complete item O and item P, Q, or R.

O Check the applicable box to indicate whether the corporation is:

- 1. A new corporation **adopting** the tax year entered in item F, Part I.
- 2. An existing corporation **retaining** the tax year entered in item F, Part I.
- 3. An existing corporation **changing** to the tax year entered in item F, Part I.

P Complete item P if the corporation is using the automatic approval provisions of Rev. Proc. 2006-46, 2006-45 I.R.B. 859, to request **(1)** a natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) or **(2)** a year that satisfies the ownership tax year test (as defined in section 5.08 of Rev. Proc. 2006-46). Check the applicable box below to indicate the representation statement the corporation is making.

1. Natural Business Year ▶ I represent that the corporation is adopting, retaining, or changing to a tax year that qualifies as its natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) and has attached a statement showing separately for each month the gross receipts for the most recent 47 months (see instructions). I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.

2. Ownership Tax Year ▶ I represent that shareholders (as described in section 5.08 of Rev. Proc. 2006-46) holding more than half of the shares of the stock (as of the first day of the tax year to which the request relates) of the corporation have the same tax year or are concurrently changing to the tax year that the corporation adopts, retains, or changes to per item F, Part I, and that such tax year satisfies the requirement of section 4.01(3) of Rev. Proc. 2006-46. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.

Note. If you do not use item P and the corporation wants a fiscal tax year, complete either item Q or R below. Item Q is used to request a fiscal tax year based on a business purpose and to make a back-up section 444 election. Item R is used to make a regular section 444 election.

Q Business Purpose—To request a fiscal tax year based on a business purpose, check box Q1. See instructions for details including payment of a user fee. You may also check box Q2 and/or box Q3.

1. Check here ▶ if the fiscal year entered in item F, Part I, is requested under the prior approval provisions of Rev. Proc. 2002-39, 2002-22 I.R.B. 1046. Attach to Form 2553 a statement describing the relevant facts and circumstances and, if applicable, the gross receipts from sales and services necessary to establish a business purpose. See the instructions for details regarding the gross receipts from sales and services. If the IRS proposes to disapprove the requested fiscal year, do you want a conference with the IRS National Office?

Yes No

2. Check here ▶ to show that the corporation intends to make a back-up section 444 election in the event the corporation's business purpose request is not approved by the IRS. (See instructions for more information.)

3. Check here ▶ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event (1) the corporation's business purpose request is not approved and the corporation makes a back-up section 444 election, but is ultimately not qualified to make a section 444 election, or (2) the corporation's business purpose request is not approved and the corporation did not make a back-up section 444 election.

R Section 444 Election—To make a section 444 election, check box R1. You may also check box R2.

1. Check here ▶ to show that the corporation will make, if qualified, a section 444 election to have the fiscal tax year shown in item F, Part I. To make the election, you must complete **Form 8716**, Election To Have a Tax Year Other Than a Required Tax Year, and either attach it to Form 2553 or file it separately.

2. Check here ▶ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event the corporation is ultimately not qualified to make a section 444 election.

Part III Qualified Subchapter S Trust (QSST) Election Under Section 1361(d)(2)*

Income beneficiary's name and address	Social security number
	: : : :
Trust's name and address	Employer identification number
	: :
Date on which stock of the corporation was transferred to the trust (month, day, year) ▶ / /	

In order for the trust named above to be a QSST and thus a qualifying shareholder of the S corporation for which this Form 2553 is filed, I hereby make the election under section 1361(d)(2). Under penalties of perjury, I certify that the trust meets the definitional requirements of section 1361(d)(3) and that all other information provided in Part III is true, correct, and complete.

Signature of income beneficiary or signature and title of legal representative or other qualified person making the election _____ Date _____

*Use Part III to make the QSST election only if stock of the corporation has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation. The QSST election must be made and filed separately if stock of the corporation is transferred to the trust **after** the date on which the corporation makes the S election.

Department of the Treasury
Internal Revenue Service

▶ Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.

2009

▶ See separate instructions.

For calendar year 2009 or tax year beginning _____, 2009, ending _____, 20

A S election effective date	Use IRS label. Otherwise, print or type.	Name	D Employer identification number
B Business activity code number (see instructions)		Number, street, and room or suite no. If a P.O. box, see instructions.	E Date incorporated
C Check if Sch. M-3 attached <input type="checkbox"/>		City or town, state, and ZIP code	F Total assets (see instructions) \$ _____

G Is the corporation electing to be an S corporation beginning with this tax year? Yes No If "Yes," attach Form 2553 if not already filed

H Check if: (1) Final return (2) Name change (3) Address change
(4) Amended return (5) S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year _____ ▶

Caution. Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.

Income	1 a Gross receipts or sales	b Less returns and allowances	c Bal ▶	1c	
	2 Cost of goods sold (Schedule A, line 8)			2	
	3 Gross profit. Subtract line 2 from line 1c			3	
	4 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			4	
	5 Other income (loss) (see instructions—attach statement)			5	
	6 Total income (loss). Add lines 3 through 5			6	
Deductions (see instructions for limitations)	7 Compensation of officers			7	
	8 Salaries and wages (less employment credits)			8	
	9 Repairs and maintenance			9	
	10 Bad debts			10	
	11 Rents			11	
	12 Taxes and licenses			12	
	13 Interest			13	
	14 Depreciation not claimed on Schedule A or elsewhere on return (attach Form 4562)			14	
	15 Depletion (Do not deduct oil and gas depletion.)			15	
	16 Advertising			16	
	17 Pension, profit-sharing, etc., plans			17	
	18 Employee benefit programs			18	
	19 Other deductions (attach statement)			19	
	20 Total deductions. Add lines 7 through 19			20	
	21 Ordinary business income (loss). Subtract line 20 from line 6			21	
Tax and Payments	22a Excess net passive income or LIFO recapture tax (see instructions)	22a			
	b Tax from Schedule D (Form 1120S)	22b			
	c Add lines 22a and 22b (see instructions for additional taxes)			22c	
	23a 2009 estimated tax payments and 2008 overpayment credited to 2009	23a			
	b Tax deposited with Form 7004	23b			
	c Credit for federal tax paid on fuels (attach Form 4136)	23c			
	d Add lines 23a through 23c			23d	
	24 Estimated tax penalty (see instructions). Check if Form 2220 is attached			24	
	25 Amount owed. If line 23d is smaller than the total of lines 22c and 24, enter amount owed			25	
	26 Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid			26	
27 Enter amount from line 26 Credited to 2010 estimated tax ▶		Refunded ▶	27		

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Sign Here Signature of officer _____ Date _____ Title _____

May the IRS discuss this return with the preparer shown below (see instructions)? Yes No

Paid Preparer's Use Only Preparer's signature _____ Date _____ Check if self-employed Preparer's SSN or PTIN _____
Firm's name (or yours if self-employed), address, and ZIP code _____ EIN _____
Phone no. _____

Schedule A Cost of Goods Sold (see instructions)

1	Inventory at beginning of year	1		
2	Purchases	2		
3	Cost of labor	3		
4	Additional section 263A costs (<i>attach statement</i>)	4		
5	Other costs (<i>attach statement</i>)	5		
6	Total. Add lines 1 through 5	6		
7	Inventory at end of year	7		
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8		
9a	Check all methods used for valuing closing inventory: (i) <input type="checkbox"/> Cost as described in Regulations section 1.471-3 (ii) <input type="checkbox"/> Lower of cost or market as described in Regulations section 1.471-4 (iii) <input type="checkbox"/> Other (Specify method used and attach explanation.) ▶			
b	Check if there was a writedown of subnormal goods as described in Regulations section 1.471-2(c)			<input type="checkbox"/>
c	Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970)			<input type="checkbox"/>
d	If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO	9d		
e	If property is produced or acquired for resale, do the rules of section 263A apply to the corporation?		<input type="checkbox"/> Yes	<input type="checkbox"/> No
f	Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation.		<input type="checkbox"/> Yes	<input type="checkbox"/> No

Schedule B Other Information (see instructions)

	Yes	No
1 Check accounting method: a <input type="checkbox"/> Cash b <input type="checkbox"/> Accrual c <input type="checkbox"/> Other (specify) ▶		
2 See the instructions and enter the: a Business activity ▶ b Product or service ▶		
3 At the end of the tax year, did the corporation own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a statement showing: (a) name and employer identification number (EIN), (b) percentage owned, and (c) if 100% owned, was a QSub election made?		
4 Has this corporation filed, or is it required to file, a return under section 6111 to provide information on any reportable transaction?		
5 Check this box if the corporation issued publicly offered debt instruments with original issue discount <input type="checkbox"/> If checked, the corporation may have to file Form 8281 , Information Return for Publicly Offered Original Issue Discount Instruments.		
6 If the corporation: (a) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation and (b) has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years ▶ \$		
7 Enter the accumulated earnings and profits of the corporation at the end of the tax year. \$		
8 Are the corporation's total receipts (<i>see instructions</i>) for the tax year and its total assets at the end of the tax year less than \$250,000? If "Yes," the corporation is not required to complete Schedules L and M-1		

Schedule K Shareholders' Pro Rata Share Items

		Total amount
1 Ordinary business income (loss) (page 1, line 21)	1	
2 Net rental real estate income (loss) (<i>attach Form 8825</i>)	2	
3a Other gross rental income (loss) 3a		
b Expenses from other rental activities (<i>attach statement</i>) 3b		
c Other net rental income (loss). Subtract line 3b from line 3a 3c		
4 Interest income 4		
5 Dividends: a Ordinary dividends 5a b Qualified dividends 5b		
6 Royalties 6		
7 Net short-term capital gain (loss) (<i>attach Schedule D (Form 1120S)</i>) 7		
8a Net long-term capital gain (loss) (<i>attach Schedule D (Form 1120S)</i>) 8a		
b Collectibles (28%) gain (loss) 8b		
c Unrecaptured section 1250 gain (<i>attach statement</i>) 8c		
9 Net section 1231 gain (loss) (<i>attach Form 4797</i>) 9		
10 Other income (loss) (<i>see instructions</i>) Type ▶ 10		

		Shareholders' Pro Rata Share Items (continued)	Total amount	
Deductions	11	Section 179 deduction (<i>attach Form 4562</i>)	11	
	12a	Contributions	12a	
	b	Investment interest expense	12b	
	c	Section 59(e)(2) expenditures (1) Type ▶ _____ (2) Amount ▶ _____	12c(2)	
	d	Other deductions (<i>see instructions</i>) Type ▶ _____	12d	
Credits	13a	Low-income housing credit (section 42(j)(5))	13a	
	b	Low-income housing credit (other)	13b	
	c	Qualified rehabilitation expenditures (rental real estate) (<i>attach Form 3468</i>)	13c	
	d	Other rental real estate credits (<i>see instructions</i>) Type ▶ _____	13d	
	e	Other rental credits (<i>see instructions</i>) Type ▶ _____	13e	
	f	Alcohol and cellulosic biofuel fuels credit (<i>attach Form 6478</i>)	13f	
	g	Other credits (<i>see instructions</i>) Type ▶ _____	13g	
Foreign Transactions	14a	Name of country or U.S. possession ▶ _____		
	b	Gross income from all sources	14b	
	c	Gross income sourced at shareholder level <i>Foreign gross income sourced at corporate level</i>	14c	
	d	Passive category	14d	
	e	General category	14e	
	f	Other (<i>attach statement</i>) <i>Deductions allocated and apportioned at shareholder level</i>	14f	
	g	Interest expense	14g	
	h	Other <i>Deductions allocated and apportioned at corporate level to foreign source income</i>	14h	
	i	Passive category	14i	
	j	General category	14j	
	k	Other (<i>attach statement</i>) <i>Other information</i>	14k	
	l	Total foreign taxes (check one): ▶ <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	14l	
	m	Reduction in taxes available for credit (<i>attach statement</i>)	14m	
	n	Other foreign tax information (<i>attach statement</i>)		
Alternative Minimum Tax (AMT) Items	15a	Post-1986 depreciation adjustment	15a	
	b	Adjusted gain or loss	15b	
	c	Depletion (other than oil and gas)	15c	
	d	Oil, gas, and geothermal properties—gross income	15d	
	e	Oil, gas, and geothermal properties—deductions	15e	
	f	Other AMT items (<i>attach statement</i>)	15f	
Items Affecting Shareholder Basis	16a	Tax-exempt interest income	16a	
	b	Other tax-exempt income	16b	
	c	Nondeductible expenses	16c	
	d	Property distributions	16d	
	e	Repayment of loans from shareholders	16e	
Other Information	17a	Investment income	17a	
	b	Investment expenses	17b	
	c	Dividend distributions paid from accumulated earnings and profits	17c	
	d	Other items and amounts (<i>attach statement</i>)		
Reconciliation	18	Income/loss reconciliation. Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 14l	18	

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
Assets					
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts	()		()	
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach statement)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)				
10a	Buildings and other depreciable assets				
b	Less accumulated depreciation	()		()	
11a	Depletable assets				
b	Less accumulated depletion	()		()	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	()		()	
14	Other assets (attach statement)				
15	Total assets				
Liabilities and Shareholders' Equity					
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach statement)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach statement)				
22	Capital stock				
23	Additional paid-in capital				
24	Retained earnings				
25	Adjustments to shareholders' equity (attach statement)				
26	Less cost of treasury stock		()		()
27	Total liabilities and shareholders' equity				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return
Note: Schedule M-3 required instead of Schedule M-1 if total assets are \$10 million or more—see instructions

1	Net income (loss) per books		5	Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize): _____		a	Tax-exempt interest \$ _____	
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14l (itemize):		6	Deductions included on Schedule K, lines 1 through 12 and 14l, not charged against book income this year (itemize):	
a	Depreciation \$ _____		a	Depreciation \$ _____	
b	Travel and entertainment \$ _____		7	Add lines 5 and 6	
4	Add lines 1 through 3		8	Income (loss) (Schedule K, line 18). Line 4 less line 7	

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see instructions)

	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year		
2	Ordinary income from page 1, line 21		
3	Other additions		
4	Loss from page 1, line 21	()	
5	Other reductions	()	
6	Combine lines 1 through 5		
7	Distributions other than dividend distributions		
8	Balance at end of tax year. Subtract line 7 from line 6		

**Schedule K-1
(Form 1120S)**
Department of the Treasury
Internal Revenue Service

2009

For calendar year 2009, or tax
year beginning _____, 2009
ending _____, 20____

**Shareholder's Share of Income, Deductions,
Credits, etc.** ▶ See back of form and separate instructions.

Part I Information About the Corporation		Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items	
A Corporation's employer identification number		1 Ordinary business income (loss)	13 Credits
B Corporation's name, address, city, state, and ZIP code		2 Net rental real estate income (loss)	
		3 Other net rental income (loss)	
		4 Interest income	
C IRS Center where corporation filed return		5a Ordinary dividends	
		5b Qualified dividends	14 Foreign transactions
		6 Royalties	
Part II Information About the Shareholder		7 Net short-term capital gain (loss)	
	D Shareholder's identifying number	8a Net long-term capital gain (loss)	
		8b Collectibles (28%) gain (loss)	
E Shareholder's name, address, city, state, and ZIP code	8c Unrecaptured section 1250 gain		
	9 Net section 1231 gain (loss)		
F Shareholder's percentage of stock ownership for tax year _____ %		10 Other income (loss)	15 Alternative minimum tax (AMT) items
	For IRS Use Only	11 Section 179 deduction	16 Items affecting shareholder basis
		12 Other deductions	
			17 Other information
* See attached statement for additional information.			

This list identifies the codes used on Schedule K-1 for all shareholders and provides summarized reporting information for shareholders who file Form 1040. For detailed reporting and filing information, see the separate Shareholder's Instructions for Schedule K-1 and the instructions for your income tax return.

- 1. Ordinary business income (loss).** Determine whether the income (loss) is passive or nonpassive and enter on your return as follows:
 - Passive loss *Report on* See the Shareholder's Instructions
 - Passive income Schedule E, line 28, column (g)
 - Nonpassive loss Schedule E, line 28, column (h)
 - Nonpassive income Schedule E, line 28, column (j)
- 2. Net rental real estate income (loss)** See the Shareholder's Instructions
- 3. Other net rental income (loss)**
 - Net income Schedule E, line 28, column (g)
 - Net loss See the Shareholder's Instructions
- 4. Interest income** Form 1040, line 8a
- 5a. Ordinary dividends** Form 1040, line 9a
- 5b. Qualified dividends** Form 1040, line 9b
- 6. Royalties** Schedule E, line 4
- 7. Net short-term capital gain (loss)** Schedule D, line 5, column (f)
- 8a. Net long-term capital gain (loss)** Schedule D, line 12, column (f)
- 8b. Collectibles (28%) gain (loss)** 28% Rate Gain Worksheet, line 4 (Schedule D instructions)
- 8c. Unrecaptured section 1250 gain** See the Shareholder's Instructions
- 9. Net section 1231 gain (loss)** See the Shareholder's Instructions
- 10. Other income (loss)** See the Shareholder's Instructions

- | <i>Code</i> | <i>Report on</i> |
|---|------------------------------------|
| A Other portfolio income (loss) | See the Shareholder's Instructions |
| B Involuntary conversions | See the Shareholder's Instructions |
| C Sec. 1256 contracts & straddles | Form 6781, line 1 |
| D Mining exploration costs recapture | See Pub. 535 |
| E Other income (loss) | See the Shareholder's Instructions |
- 11. Section 179 deduction** See the Shareholder's Instructions
 - 12. Other deductions**
 - A** Cash contributions (50%)
 - B** Cash contributions (30%)
 - C** Noncash contributions (50%)
 - D** Noncash contributions (30%)
 - E** Capital gain property to a 50% organization (30%)
 - F** Capital gain property (20%)
 - G** Contributions (100%)
 - H** Investment interest expense Form 4952, line 1
 - I** Deductions—royalty income Schedule E, line 18
 - J** Section 59(e)(2) expenditures See the Shareholder's Instructions
 - K** Deductions—portfolio (2% floor) Schedule A, line 23
 - L** Deductions—portfolio (other) Schedule A, line 28
 - M** Preproductive period expenses See the Shareholder's Instructions
 - N** Commercial revitalization deduction from rental real estate activities See Form 8582 instructions
 - O** Reforestation expense deduction See the Shareholder's Instructions
 - P** Domestic production activities information See Form 8903 instructions
 - Q** Qualified production activities income Form 8903, line 7
 - R** Employer's Form W-2 wages Form 8903, line 15
 - S** Other deductions See the Shareholder's Instructions

- 13. Credits**
 - A** Low-income housing credit (section 42(j)(5)) from pre-2008 buildings See the Shareholder's Instructions
 - B** Low-income housing credit (other) from pre-2008 buildings See the Shareholder's Instructions
 - C** Low-income housing credit (section 42(j)(5)) from post-2007 buildings Form 8586, line 11
 - D** Low-income housing credit (other) from post-2007 buildings Form 8586, line 11
 - E** Qualified rehabilitation expenditures (rental real estate)
 - F** Other rental real estate credits
 - G** Other rental credits
 - H** Undistributed capital gains credit Form 1040, line 70, box 4
 - I** Alcohol and cellulosic biofuel fuels credit Form 6478, line 7
 - J** Work opportunity credit Form 5884, line 3
 - K** Disabled access credit See the Shareholder's Instructions
 - L** Empowerment zone and renewal community employment credit Form 8844, line 3

- | <i>Code</i> | <i>Report on</i> |
|---|------------------------------------|
| M Credit for increasing research activities | See the Shareholder's Instructions |
| N Credit for employer social security and Medicare taxes | Form 8846, line 5 |
| O Backup withholding | Form 1040, line 61 |
| P Other credits | See the Shareholder's Instructions |
- 14. Foreign transactions**
 - A** Name of country or U.S. possession
 - B** Gross income from all sources
 - C** Gross income sourced at shareholder level
 - Foreign gross income sourced at corporate level*
 - D** Passive category
 - E** General category
 - F** Other
 - Deductions allocated and apportioned at shareholder level*
 - G** Interest expense Form 1116, Part I
 - H** Other Form 1116, Part I
 - Deductions allocated and apportioned at corporate level to foreign source income*
 - I** Passive category
 - J** General category
 - K** Other
 - Other information*
 - L** Total foreign taxes paid Form 1116, Part II
 - M** Total foreign taxes accrued Form 1116, Part II
 - N** Reduction in taxes available for credit Form 1116, line 12
 - O** Foreign trading gross receipts Form 8873
 - P** Extraterritorial income exclusion Form 8873
 - Q** Other foreign transactions See the Shareholder's Instructions
- 15. Alternative minimum tax (AMT) items**
 - A** Post-1986 depreciation adjustment
 - B** Adjusted gain or loss
 - C** Depletion (other than oil & gas)
 - D** Oil, gas, & geothermal—gross income
 - E** Oil, gas, & geothermal—deductions
 - F** Other AMT items
 - 16. Items affecting shareholder basis**
 - A** Tax-exempt interest income Form 1040, line 8b
 - B** Other tax-exempt income
 - C** Nondeductible expenses
 - D** Property distributions
 - E** Repayment of loans from shareholders
 - 17. Other information**
 - A** Investment income Form 4952, line 4a
 - B** Investment expenses Form 4952, line 5
 - C** Qualified rehabilitation expenditures (other than rental real estate) See the Shareholder's Instructions
 - D** Basis of energy property See the Shareholder's Instructions
 - E** Recapture of low-income housing credit (section 42(j)(5)) Form 8611, line 8
 - F** Recapture of low-income housing credit (other) Form 8611, line 8
 - G** Recapture of investment credit See Form 4255
 - H** Recapture of other credits See the Shareholder's Instructions
 - I** Look-back interest—completed long-term contracts See Form 8697
 - J** Look-back interest—income forecast method See Form 8866
 - K** Dispositions of property with section 179 deductions
 - L** Recapture of section 179 deduction
 - M** Section 453(l)(3) information
 - N** Section 453A(c) information
 - O** Section 1260(b) information
 - P** Interest allocable to production expenditures
 - Q** CCF nonqualified withdrawals
 - R** Depletion information—oil and gas
 - S** Amortization of reforestation costs
 - T** Section 108(j) information
 - U** Other information